TAX HAVENS - MECHANICS AND MEANS

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WHAT IS A TAX HAVEN ?

It is a place or a country where foreigners or non-residents receive income or own assets without paying high rate of tax thereon. The tax relief that such non-residents enjoy emerges some times from the absence of the chief forms of direct taxation like Income Tax, Estate Duty, Gift Tax; but in most of the countries the relief comes from special features of the tax system that results in a very low or nominal effective rate of tax on certain forms of foreign investment. Examples of such tax havens are Hong Kong, the Bahamas, Bermuda, Liberia, the Netherlands, the New Hebrides, Panama, and Switzerland. Some of the countries that enjoy a reputation as tax havens have cultivated it. In others, the features that make them a tax haven are merely a consequence of their having followed certain principles of taxation. It is interesting to note that most of the tax haven are developing countries. They are the pace-setters for other developing countries who feel that becoming a tax haven will help solve some of their economic problems. There is no denying the fact that the tax haven status does yield benefits to the tax haven country but it is not a panacea for a country's economic ills.

The modus operandi : Tax havens are used for a great variety of operations. They minimize the taxpayer's total tax burden by subjecting at least a part of his income or wealth to a lower effective rate than would otherwise be applicable.

Much "tax haven" business is fictitious, in the sense that little or none of it is effectively carried out in the tax haven proper. Goods that are bought and sold by tax haven subsidiaries often do not pass through the tax haven's territory; they move directly from the country of origin to the country of destination. The assets of trusts that are established in tax havens are usually kept thousands of miles away; and neither the guarantor nor the beneficiary is normally resident in the tax haven country.

Tax haven operations consist fundamentally in establishing within a tax haven country one or more legal entities, such as trusts, personal holding companies, or corporate subsidiaries, and attributing to them income earned elsewhere in order that it should be taxed at the country's low rates - or perhaps not taxed at all. This objective is usually accomplished by either :

(1) accumulating income in the tax haven country at low rates of tax, to be withdrawn later and invested elsewhere according to the investor's wishes; or

(2) artificially shifting business profits from high-tax countries to a tax haven country.

In the case of passive investment, from which dividends, interest, or royalties are derived, trusts and personal holding companies are used as buffers or screens between the real investor and his assets. For many years the creation of these legal entities for the purpose of obtaining a tax advantage was among the most popular uses of tax havens. As a result of counter measures that have been enacted, this has apparently not increased as fast as other tax haven activities.

The most rapidly growing type of tax haven operation is that of shifting business profits from high-tax countries to tax haven countries. These are usually carried out by large corporations through tax haven subsidiaries, using sophisticated methods that are designed to diminish the tax base artificially in high-tax jurisdictions while increasing it in the tax haven country.

The most important of these methods involves transfer pricing the setting of prices on goods and services that are bought and sold between a parent company and its foreign subsidiary. No "arm's length" bargaining takes place between these parties, so the prices that are set can be manipulated to minimize the enterprise's total taxes. (The "arm's length" relationship implies dealings between two independent and unrelated parties, where prices are determined according to market forces.) For example, a company may sell goods at an artificially low price to its subsidiary in a tax haven country. Thus, it shows only a small profit on which it has to pay a low tax, or perhaps even a loss. Its subsidiary then resells the goods to the ultimate buyer at the normal price, earning a large profit, all of which however is taxed at a low rate, or not taxed at all.

Another type of activity is carried out by the financial sector. In most of these countries there exists a financial sector whose size and importance are out of proportion to the size and resources of the country itself. This sector usually comprises a large number of bonds and trust companies, most of which are branches or subsidiaries of foreign-owned institutions. The reasons for their presence in tax haven countries are quite varied. These institutions manage trusts and holding companies that have been established to shelter foreign passive investment income; they hold deposits for foreign investors; they provide administrative facilities for a variety of corporate subsidiaries. Foreign banks also use "shell" banks or branches located in tax haven countries to do currency business.

The activities of the financial sector are largely of an ancillary or dependent nature. The main object of many of these banks or trust companies is to provide services to other tax haven activities such as administering tax haven trusts and corporate subsidiaries and holding deposits for foreign investors. Much of the business of this sector is "real" business in the tax haven. Banks and trust companies that administer trusts or holding companies do a large amount of the technical, audit, and legal work of administration in the tax haven country. In other cases, however, the "real" activity is carried out elsewhere, except perhaps for a nominal presence in the tax haven.

Tax havens also attract foreigners who come to work for Foreign banks or other companies, and retired persons, who decide to establish their residence where the advantage of a temperate climate is joined to that of a low-tax environment.

Tax and other advantages : Low tax rates are perhaps the principal attraction offered by tax havens. Though it is true that many of the advantages offered by tax haven countries are income tax advantages, these are by no means the only benefit that these countries offer to foreign investors.

Within the tax field, the absence of other taxes such as estate, inheritance, and gift taxes may be as important to certain investors as the absence of income tax. Bilateral tax treaties between a tax haven country and some of the major developed countries are another feature that may attract investors. The existence of a tax treaty allows third-country investors to base their holding companies in tax havens and obtain a reduction in withholding taxes applied to the dividends and interest they

receive from developed countries with which the tax haven country has the tax treaty.

Strict and well-enforced rules of banking secrecy and, in general, possibility of doing business without close supervision by government agencies are additional attractions usually offered by tax haven countries. Other factors, such as the low cost of doing business, the existence of liberal banking regulations, and the absence of exchange controls are also important. Finally, a good communications service, a well developed legal system with an abundance of legal and accounting expertise, and, above all, a high degree of political and financial stability also help to make a country successful as a tax haven.

Countering tax loopholes : Are these all elements necessary to enable tax payers from high-tax jurisdictions to minimize their tax burdens? In fact, there is one other element without which they could not do so and that is the existence of features in the tax systems of developed countries that allow tax-payers to take advantage of the benefits offered by tax haven countries. Among these features are, for example, the more favorable tax treatment granted to trusts located abroad than to domestic trusts; and the mechanism of tax deferral that allows taxpayers of high-tax countries to defer income tax payments on income from foreign sources until it is repatriated. As long as these provisions remain in effect, high-tax countries cannot place all the blame on tax haven for the losses of revenue they suffers.

In general, legislation is aimed at one or both of the following objectives:

(1) preventing the tax-free accumulation by tax haven countries of certain forms of income, such as passive investment income and income derived from the assignment of service contracts to a foreign subsidiary; and

(2) attacking the problem of transfer pricing, by attempting to tax a parent company on the profits it would have obtained if the transaction with its subsidiary had taken place at arm's length.

The tax systems of a number of industrialized countries permit domestic companies to postpone the payment of taxes on profits earned by foreign subsidiaries until those profits are repatriated. This has made attractive the establishment of foreign personal holding companies in tax haven countries that can accumulate income either free of tax or subject to a very low effective rate. The rules enacted in some developed countries to prevent this accumulation generally require the income of theses foreign holding companies to be taxed on an accrual basis, thereby eliminating the tax deferral privilege that the owners previously enjoyed.

Reasons why these rules are complex : Perhaps the main reason is the wish of the developed countries to soften their impact upon companies that are accumulating income in low-tax jurisdictions for normal business reasons, without intending to avoid taxes. To achieve this purpose, anti-accumulation rules rely heavily on percentage criteria, which are objective but at the same time leave a wide margin for maneuvering by taxpayers. Thus the anti-accumulation rules usually apply only when the subsidiary established in a low-tax country is "controlled" by taxpayers in the high-tax country.

Transfer pricing : Anti-accumulation rules appear to have been more successful than the provisions designed to curb the use of transfer pricing to shift income from high-tax to low-tax jurisdictions. The tax laws of several developed countries contain provisions to ensure that sales and other operations carried out between domestic corporations and their foreign subsidiaries are transacted at arm's length prices. These provisions are difficult to administer, since the actual determination of the arm's length price is fraught with complexity.

As a result, the provisions against the use of tax havens that developed countries have introduced have mainly affected the accumulation of passive investment income in tax haven countries by making them more costly and complex. Therefore, the accumulation of income by holding companies and trusts is still possible, but only for very wealthy investors or the large corporations. As the latter are also the corporations that use transfer pricing to shift income to tax havens, and as transfer pricing practices have not been much affected by the provisions against the use of tax havens, it is probable that the "clients" of tax havens are increasingly being drawn from higher income and greater-wealth brackets.

BENEFITS TO THE TAX HAVEN :

For developing economies one of the main apparent advantages of being a tax haven is the possibility of achieving a higher employment level. This is particularly attractive to countries with a narrow resource base, which tend to have chronic unemployment problems.

However, there is a tendency to exaggerate the number of jobs created by tax haven activities. The establishment of hundreds and even thousands of corporations and trusts and the large number of transactions that technically take place in tax haven countries are generally accomplished by using little manpower within the tax haven country. For example, the institutions in the financial sector, which are the principal generators of employment opportunities and additional demand for services within the tax haven, usually prefer to staff their organizations with expatriates - particularly in the higher positions - so not all the jobs created by this activity will be available for nationals of the host country.

Other economic activities are also stimulated by tax haven operations. Construction is boosted, principally of commercial buildings. As in the case of employment, the number of new buildings required is much smaller than the size of the tax haven sector might indicate. Only those enterprises that actually do something require sizeable office space to carry out their activities. Another activity that may be stimulated is tourism, particularly if the country enjoys an agreeable climate and meetings of directors in the country are a requirement for incorporation. A tax haven country may also attract retired persons as residents, and their presence provides employment opportunities and helps bring in foreign exchange.

The existence of a large financial sector may also help a country maintain a free and open foreign exchange and payments system. In addition, the advantage of having a readily accessible financial market is considerable. Government bond issues may be underwritten or subscribed to by foreign banks, thereby making funds available for public investment and economic development.

Finally, the tax haven sector is a source of revenue to the government. There will always be some form of tax or fee for which the foreign investor will be liable. These contributions range from a simple annual fee payable by all corporations established in the country to income tax on profits considered to be of domestic origin.

THE DRAWBACKS :

The problems created and constraints imposed by the tax haven status vary according to the degree of development of the country, the size and composition of its tax haven sector, and the kind of benefits granted to this sector. In general terms, the most troublesome problems arise in developing countries where the tax haven sector contributes a relatively important share to country's gross national product (GNP).

At first glance this may appear paradoxical. The fact that the tax haven sector is contributing substantially to GNP should mean that new economic activity is taking place, which is desirable. This is true, but tax haven activity generates very little investment in tangible assets; therefore, tax haven business is extremely volatile and lacking in stability.

The one sector that does engage in real economic activity - the financial sector - is heavily dependent on what occurs in the rest of the tax haven sector. if this foreign business disappears, the domestic activity will not be sufficient to retain the large number of banks, insurance companies, and other organizations that form the financial sector of a tax haven country.

Tax haven activity is highly sensitive to national and international developments. Within a tax haven country itself, the slightest whiff of financial scandal is enough to send investors in search of another tax haven that offers more security. Situations such as these are difficult to prevent, as investors look for absolute secrecy and as little prying as possible by government officials into their affairs.

Another factor is the suspicion that country's leaders are considering important changes that may include nationalization or other radical measures. Even the smallest indication of this may precipitate a flight of depositors and other investors. A tax haven government must also be cautious about hinting that it may change its policies to meet revenue demands, for such hints may destabilize the tax haven sector. This seriously constrains the formulation of coherent domestic tax policy, as there is natural reluctance among authorities to jeopardize the tax haven sector by any changes, however necessary, in the tax system.

INTERNATIONAL FACTORS :

Internationally, one of the factors that can influence tax haven investment is the attitude of developed countries toward this activity. The measures against the use of tax havens already taken by them have all had some impact. Future measures are already being studied by some developed countries that will make the use of tax havens more costly and complex than it is at present.

Fluctuations in the world economy and disturbances in international financial markets also affect tax haven activities. Competition among tax havens trying to outdo one another by offering more stability, lower taxes, and better commercial facilities accentuates the volatility of tax haven investment.

Tax haven countries tend to be more vulnerable to external factors than developing countries that are not tax havens. Not only are they sensitive to changes in international commodity prices like other developing countries, as well as to international economic fluctuations, but they are also directly affected by the tax policies of developed countries, which are beyond their control. Accordingly, the greater their dependence on tax haven activities, the more unstable is their economic situation. These considerations, together with the constraints that the tax haven status places on the formulation of national fiscal policies, suggest that developing countries should think twice before aspiring to become tax havens. Meanwhile, those that are already tax havens should try to diminish their dependence on the activities of this sector.