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Tax Havens - An Insidious Mechanism for Evading Tax Obligations

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ABSTRACT: The development of world trade along with accelerated globalization has an effect not only on economic development or the strengthening of international cooperation, but also facilitated sophisticated mechanisms by which the payment of tax obligations by multinational companies is circumvented. Transfer pricing and tax havens, considered both individual and combined practices, negatively affect a country's ability to implement fiscal policy and improve budget revenue collection capacity. The problem is even greater in the case of states with a fragile economy, where the dynamics of development is vitally related to the elimination of legal, immoral or illegal tax evasion practices. The Transfer pricing mechanism has also been optimized to handle taxable transactions between companies affiliated to a particular group. Multinational companies avoid taxes by overestimating imports and underestimating exports, thus managing to distribute revenues in various regions of the globe that have great tax advantages.

KEYWORDS: tax havens, profit shifting, tax evasion, corporation, fiscal legislation

Introduction

Offshore tax havens are the most used tool to avoid paying taxes and duties due to the state budget, both for individuals and especially for large corporations operating throughout the world. Both actors often take advantage of too lax laws or vulnerabilities in current legal regulations. One of the reasons this is happening is that corporate income tax is not standardized and adapted to the realities that globalization has brought today.

Taxes on turnover, income or profit, universally called "corporate tax" in the corporate language of English origin was designed with the idea that multinationals can be taxed through each subsidiary in which they operate. Today, however, this idea is no longer valid. Large companies, some of them with higher turnover than many states, use lobbyists, lawyers or consultants to outsource their profits to tax havens, where not only are they not taxed, but gain full anonymity.

Results and discussions

There are mainly two techniques used by companies to move their profits to tax havens. The first is the loan between subsidiaries in the same group. Usually, a subsidiary in a country that taxes massive profits such as France accumulates debt by lending to another subsidiary. The goal is to accumulate profit in a state like Luxembourg, considered a tax haven. Luxembourg is a Member State of the European Union that raises suspicions anyway, but loans to countries such as Haiti, Bermuda or the Canary Islands raise even more questions.

In order to avoid the curious eyes of the authorities, the multinationals resort to "transfer pricing", meaning the price values at which the transactions between companies are performed at intra-group level (Zucman 2017). The manipulation of these transfer prices is more difficult to detect by the authorities and plays a more important role in this technique of avoiding taxation by Member States. Subsidiaries of multinationals located in tax havens charge extremely expensive services for subsidiaries in EU Member States or other countries in the world with high taxes and duties. Theoretically, this technique should be used in accordance with the market price, or with what specialists call "arm's length price" or "equity transaction". But the multitude of daily transactions that sometimes even a single multinational performs makes it downright impossible for authorities to follow the use of this principle in transactions.

In this regard, the case of Bermuda is very eloquent. There are many corporations, especially those in the IT field based in this country, as shown by the "LuxLeaks" or "Paradise Paper" scandals. Bermuda has a 0% profit tax, which means that all these multinationals that charge services to other countries in the group and accumulate a considerable profit margin are exempt from paying taxes. Therefore, the calculations are made so that a large part of the profit reaches these tax havens such as Bermuda (Henry 2016).

1. Tax evasion mechanisms are becoming increasingly sophisticated

The latest international transactions show us a worrying number of such schemes, especially as subsidiaries of companies choose to sell each other trademarks, logos, algorithms or feasibility studies i.e., intellectual property rights that have a market value that is difficult to define. Therefore, it is not very risky for them to manipulate prices and outsource profits. Google, Apple, Samsung can do this very easily, because they work with a lot of software and very few material assets. This is way only a mechanism like the so-called "GAFA tax" can bring the taxation of intangible assets at the same rates as the taxation of fixed assets in accounting.

The losses of national governments caused by the outsourcing of profits to tax havens or the relocation of businesses to states that practice race-to-the-bottom tactics are difficult to quantify. For example, in the case of the US economy corporate profits contributed as much as 14.5% to US national income in 2015. About one-third of that percentage is made up of foreign companies owned by U.S. residents who do business outside the United States or foreign residents who do business in the United States.

If we dig a little deeper to find where this money comes from, we will discover countries and jurisdictions like the Netherlands, Bermuda, Luxembourg, Ireland, Singapore and Switzerland. But if we look at the economic specifics of these countries, we see that the manufacturing industries that could generate such gains are not present. Also, the number of workers in these tax havens is small. Therefore, these states are clearly becoming a shield to avoid paying taxes in the countries of origin (Crivelli, de Mooij, and Keen 2015). The use of these tax havens began in the 1980s and saw a significant boom after the 2008 economic crisis.

According to estimates, such practices deprive the United States government of more than $ 130 billion annually, while reported in 2019 a presumptive loss of about 75 billion Euros. We can extrapolate and make similar calculations for other states, thus seeing how much money national budgets lose. This is also the reason why fiscal safe havens topic is gaining political traction, since the stake is money that could be used for social programs and policies. It is difficult to estimate when the government loses the most, when is deprived of these taxes or when promotes zero taxation. What is certain is that multinationals have the most to gain.

Also, it should be considered that the United States has a special policy that provides incentives to repatriate profits. In 2004, the US Congress decided to offer a so-called "tax holiday", taxing with a preferential tax of only 5.25% the multinationals that decided to bring their profits back to the US. The move was believed to bring a lot of money to the US state budget and boost unemployment, investment and the research and development sector. This was not the case at all, and the share of outsourced profits in tax havens increased.

On the other hand, there are countries like France that tax the profits and work of companies extremely high. Much of Google's profit in Bermuda should be taxed in France and Germany. But in these countries, the cost of taxes would greatly reduce tech giant's profits. Actually, it was precisely these policies and tactics that led Emmanuel Macron to so insistently demand the "GAFA tax" in the Council of the European Union and often summon Mark Zuckenberg to report to the European institutions.

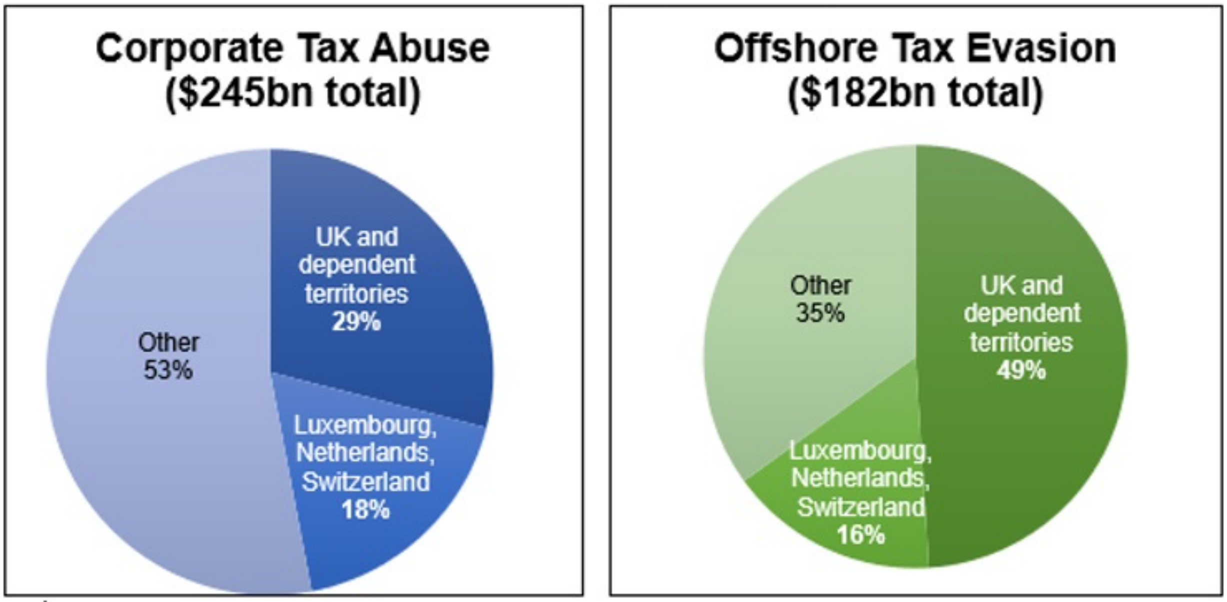

Figure 1. Countries responsible for global tax abuses (left chart).
The State of Tax Justice 2020 (rught chart)
Source: https://theconversation.com/how-global-tax-dodging-costs-lives-new-research-shows-a-direct-link-to-increased-death-rates-152275

With or without incentives, it is certain that multinationals choose to use tax havens to buy companies, guarantee loans, finance investments or even pay employees, without the governments where they operate making any profit.

Another scenario considered is the use of existing profits in tax havens to merge with foreign companies in states with "race-to-the-bottom" policy. This changes the tax residence of companies and avoids national taxation in what economists call the tax reversal process. Reversing the corporate tax actually means that a parent company is taken over by a "parent", so that it becomes a subsidiary of the company with which it merges, thus moving its tax residence to the foreign country (Cobham 2018).

A direct and natural consequence of these movements is a decline in the payment of taxes and income taxes. Although the tax base is constantly growing, taxes and fees paid by multinationals in the countries where they operate are declining (Weichenrieder A.J., Xu, F. 2019). A political priority of each government is to increase the capacity to collect taxes and prevent tax evasion. The problem with the same governments is that the evasion methods are in a grey area, not specifically regulated, thus allowing movements such as those mentioned below and reducing the percentage of collection in the state budget.

Of course, the decrease in the budget collection of corporate taxes and duties is also due to the fiscal incentives or exemptions that governments practice from time to time. It is also due to legislation that allows the deduction of corporate tax conditional on other economic and social activities. There are economic sectors, such as the IT sector in Romania, which brings great added value to the economy and is exempt from paying many taxes and duties. But structurally, tax avoidance is conducted through tax havens or jurisdictions allowing race-to-the-bottom mechanisms.

These evasive tactics practiced by multinationals not only harm the societies where these multinationals are present, but also cause significant disruptions to macroeconomic statistics, which thus lose their relevance. Take Ireland, for example, where multinationals import at very low prices and export at artificially high prices in transactions with jurisdictions such as the Isle of Man. This translates into an artificially increased trade surplus for Ireland, which is not a competitive economic advantage at all. All the benefit is transferred to the business owners (Ozili P.K. 2019). The manipulation of transfer prices increases the share capital of companies in sectors with intangible assets.

Therefore, the efforts of governments and international institutions are directed towards trying to regulate these unfair practices of multinationals. Lately, efforts have focused on regulating “price transfer” practices. But the actions of multinationals to avoid taxes seem to be intensifying. So, the institutional actions in addressing this issue do not seem to be working at the moment. This is because just as any criminal is before the police, so too will multinationals always find a way to circumvent the law.

Large multinationals have more financial and tax departments than many nations do. Politicians say higher budgets for tax fraud investigation departments would lead to a decline in these practices. But experts warn that this will only lead multinationals to spend more money and find new ways to avoid paying taxes. However, a capital reform of the profit tax is needed (Nebus 2019). We can start in this attempt from examples of good practice and from the governance of multinational companies that act in good faith and leave a correct socio-economic imprint in the countries where they operate. For example, in order to allocate profit to different subsidiaries, different indicators can be taken into account, such as sales volume, capital or employment rate. Basically, if PepsiCo has half of its sales, capital and workers in Italy, then half of its profit must be taxed in Italy (Cobham, Alex, and Petr Janský. 2017).

In a perfect situation, this formula should be designed in such a way that the profit cannot be outsourced or manipulated. Sales volume is an indicator that can be used in this regard. Another is the number of direct transactions with customers, because they cannot be moved from Belgium to the Canary Islands. It is important that the profit is shared correctly between different states, in order to allow national legislation to tax it.

Such a model would bring more predictability to global taxation. Starting from a central status of a multinational, such a model would consolidate the profits of corporations and distribute the profit fairly and equitably, depending on the profitability of each subsidiary. The practice would make the outsourcing of profits meaningless, and governments would bring more money into national budgets (Spire 2018). Even multinationals could win, because they would not have to pay hard-earned specialists to think these financial engineers. Even if their earnings are much lower than the earnings, they register by the practice of moving their profits to tax havens.

There are still several regional systems that operate according to the principles described earlier. The US federal government calculates companies' profits nationwide, and then assigns them to different states using a specific formula. Afterwards, each state sets the level of taxation.

At European level, the European Commission has proposed the Directives on the Common Corporate Tax Base (CCTB) and the Common Consolidated Corporate Tax Base (CCCTB), which contains a formula for taxing multinationals according to different criteria. The purpose of the Directives is to punish, along with other instruments, tax havens and to encourage large corporations to declare their profits in the states where they operate. However, many of these steps remain optional, so it will take a long time for the new European regulations to take effect. A major breakthrough was recently announced by the G7 group, which has reached an historic agreement on taxing multinational companies. The finance ministers of the G7 states meeting in London have agreed to commit themselves to the principle of a minimum corporate tax rate of 15%. Technology giants like Amazon and Google could be among the companies affected. The move could spill billions of dollars into governments to pay off debts incurred during the COVID crisis.

Conclusions

Recent evolutions, including G7 agrrement indicate that some of the world's largest economies, among which the United States and Europe, will soon have a centralized and standardized formula, operating on a consolidated basis and not on a state-by-state basis. In the future, the USA, the European Union, but also the rest of the relevant economies will be able to conclude trade and free trade agreements that will also provide for the taxation of multinationals. Taxation issues need to play an increasingly important role in trade agreements and policies.

Reforming the taxation methods of large corporations will bring considerable gains to national governments, and societies as a whole. In this sense, a global tax base will bring the uselessness of outsourcing profits to tax havens. Thus, these states that live only by stimulating multinationals to outsource their profits to them, will have to rethink their economic and social approach.

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