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METHODS OF TAX OPTIMISATION WITH THE USE OF TAX HAVENS

Abstract

The present study is concerned with chosen methods employed in a legal and illegal way by the taxpayers in order to reduce their tax burdens by the use of tax havens. The aim of this article is to elaborate on the phenomenon of tax competition, in particular, ways of using it for the purpose of tax optimisation. The essence of a tax haven introduced at the beginning serves as an introduction to the remaining content and lets one understand the outline of the discussed phenomenon. The presented methods cannot be considered a legal advice, but only an objective characteristic.

Key words: tax havens, offshore companies, taxes, tax law, tax avoidance.

JEL Classification: F23, H87

1. Introduction

The term "tax haven" is hard to fully define. The reason for this is that considering a country a tax haven is conventional because it is subject to an individual evaluation of a person, depending on what they expect from a given country. The name "tax haven" straightforwardly points to the tax factor and despite being crucial when choosing a country, it is not the only one. For example, it is hard to find a country attractive when tax

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rates are extremely low, where registering a company is fortified by many restrictions, or the protection of banking confidentiality is insufficient. Interest in tax havens can be of a general or individual nature, depending fully on the factor that determines our choice. Managing countries can also influence whether it will be a tax haven or not. Maximizing prosperity by seeking a country with low tax rates will not be successful if the country is poorly managed, as it may be associated with a high rate of corruption [James and Hines 2009: 13].

Globally, one aspires to protect the money and its value. However, geographic location, redistribution of income or the protection of private financial sphere can also be crucial for people looking for tax optimisation in countries different than their native one. Tax havens are a phenomenon of international tax competition which extends beyond the strictly legal consequences because it significantly affects the economy and political relations. It also has an impact on social and commercial relations which are still undergoing dynamic changes because of the progressive globalisation. A negative effect of such competition is the escape of taxpayers to the countries with a more attractive tax system. This leads to lowering the proceeds of the national budget, which is linked to a less effective fiscal system, decrease of public expenditures and searching for new sources of needs' funding. One of the advantages of this situation can be the fact that the freedom of taxpayers is a sign of democracy. This situation also leads to the compensation of the global mechanism of the distribution of the resources and also makes it possible to maintain low prices while allowing for the simultaneous high economic growth [Lipowski 2004: 122-123].

2. The concept of grey market of gambling

One of the simplest methods of tax optimisation is a shell company [Chęciński, Czerwiński 2016: 33]. It is a type of limited company; however, its functioning is prohibited and tax havens are the only place where it is allowed to be established. It effectively enables tax avoidance, because it is subject to only low tax rate of the country it was established in. Colloquially, it can be said that it exists only "on paper", because it meets solely the minimal legal constraints, its establishment in most of the countries is extremely simple and it does not require huge financial outlays. A shell company also does not require notarial deeds and complicated documents, which definitely makes it much more attractive than other types of corporations [Lipowski 2002: 162].

What is also crucial in case of these companies is that they can be bought "ready", and shares can belong fully (or mostly) to its founder (acquirer) who can be both a natural or a

legal person. They exercise full authority over it wherewithal a trustee [Lipowski 2002: 162].

This is a big threat because they can be used for crimes in which the perpetrator cannot be identified. For example, the Iranian government used shell companies, including from Malta and Cyprus to avoid sanctions for concealing the ownership of its oil tankers [Becker 2010].

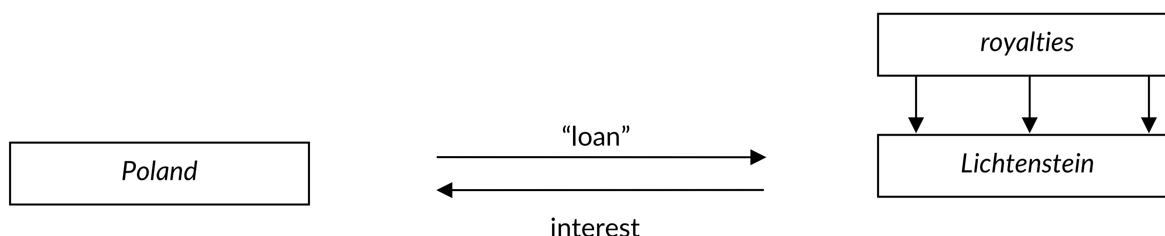
Establishing a company can be executed with the help of local consultants who need a few simple information:

- name of the founder in case of setting the company in person or the name of the trustee if they are going to be a part of it;
- name of the company - the consultants often ask for giving a few exemplary names in case some of them are already in use or if a given country has particular restrictions in this topic. Depending on the tax haven, it can top-down prohibit using certain phrases by shell companies;
- coverage - the broader it will be in the beginning, the easier it will be to modify and develop the company later. Respective tax havens can statutorily inhibit branching out during the existence of the company, which is why it is most profitable (where possible) to give information on “any statutory activity” right from the beginning;
- the amount of share capital. In most of the countries, the minimal amount is exiguous, up to 400 francs/marks. However, there are exceptions in the case of investment trusts and banks; the capital there is significantly higher and must be fully contributed;
- the name of the executive - there is an unwritten rule that the company founder should not reveal his name as an executive. It is worth to use the help of local executives and sometimes it is even a formal requirement to use tax benefits. If a given country does not have such a requirement, any trusted person can be appointed for this position;
- shareholders - colloquially called “pawns”, appear in the documents until the company is established and then they pass the shares to the actual founder. Such a phenomenon provides protection of the founder's name and at the same time requires involvement of the local attorney, which is a way of boosting services provided in tax havens;
- additional regulations and rulings of the Common Law - some regulations which will simplify the functioning of the company and, most importantly, secure the owner’s business, may need to be settled on paper. Amongst such records can be, for

example, the pre-emption right in case the shareholders decide to dispose of their shares, as well as stating the functions and appurtenances of the people employed in executive positions, or assumptions concerning the disposal of wealth. The Common Law System differs from others and before setting a company in a haven in such a system, one has to adapt to additional restrictions. However, these are not severe exacerbations, because they concern formal issues, such as the requirement to register the company's actual legal address to which the correspondence will be delivered.

- consulting services in tax havens are a key source of income for many havens, because without the support of local advisors, the companies' owners would not be able to even open their businesses. This is the reason for the high risk of price boosting in case of such services. The smaller the haven, the bigger the risk. Unfortunately, it is extremely hard to find lawyers who have knowledge and competencies concerning havens. Therefore, using the services of locals is often an only option [Winteler and Seidl 1995: 53-59].

Figure 1. Schematic representation of a shell company



Source: Lipowski 2002: 163.

Presented picture depicts the way of functioning of such a company in a simple and accurate way. The illustrated example assumes that a Polish company sets up another one in a chosen tax haven, in this case the Principality of Liechtenstein. A newly created company obtains powers to receive all royalties, as well as other proceeds such as commissions and revenue from the business activity. Cumulation of revenue in a new company with the headquarters in a tax haven allows to tax it with a low tax rate and command it freely. Revenues can be reinvested, cumulated or passed to the Polish company in a form of a loan. Such a loan requires the company to pay the interest, which constitutes costs that can also impact the presumptive tax that should be paid in Poland and lower it [Winteler and Seidl: 53-59]. In the area of financial activity, shell companies

are part of the holding and are used for transferring dividends and maintenance costs of the company. In a holding, shell company is fully dependent on a parent company [Toborek-Mazur 2010: 62].

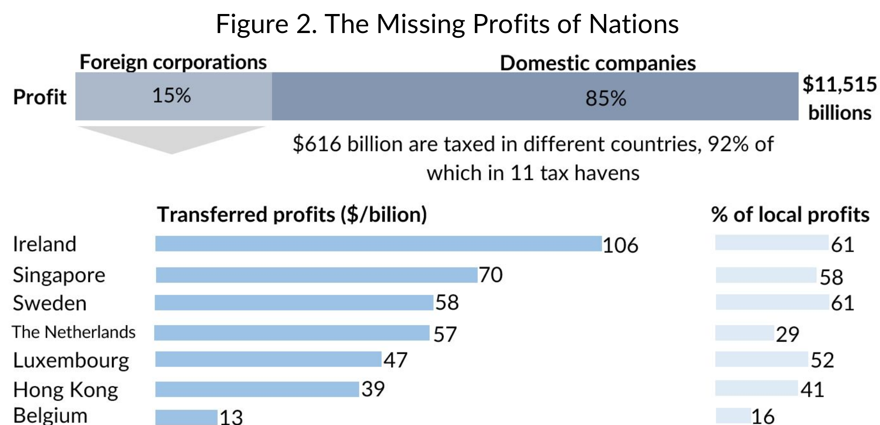
Such companies can be used for a vast range of business activity; however, on their own, their function is nothing more than just existing. They do not perform key functions when it comes to carrying out business activity; they are needed only for allocating funds from revenues on their accounts. However, not all types of business activities can be carried out in all tax havens. Each country has a right to introduce its own exclusions and uses this right. This is the next criterion for picking the right haven.

Setting up a shell company is connected with many important decisions. Even though financial issues are always crucial, here they should be treated as secondary. When compared to potential profits and costs of setting up some of the legal companies in other countries, profits are significantly bigger in this situation. Other important questions, such as tax system and political stability, play a considerable role. International standards on shell companies believe that states should take measures to combat the misuse of companies. These activities are supported by the Financial Action Task Force, which was founded in 1990 and induced as many as 180 countries to cooperate and to comply with FATF standards [Findley, Nielson and Sharman 2012: 8].

3. Transfer of profits through undercutting and inflating the prices

The definition of transfer pricing needs to be introduced before exemplifying the term and its usage. In the publications on the subject, transfer pricing are defined as prices of goods, intangible assets and services that have been decided on by affiliated companies; those prices differ from the free market prices negotiated by unaffiliated companies in comparable conditions [Sojak 2001: 69]. It is not a natural phenomenon determined by the market situation, but an initiated situation used to transfer profits and expenses between affiliated groups of entities [Dmowski 2006: 21]. According to numerous statistics and articles, it is a global problem present in most of the world's countries. In response to this phenomenon, the OECD introduced the concept of market price and assumed that the basis for determining the market price is primarily honesty [Barnhouse, Booth and Wester 2012: 6]. In order to illustrate the amount of losses that those countries suffer because of transferring profits to tax havens, a graph with chosen examples will be shown below.

Figure 2. The Missing Profits of Nations



Source: https://www.consultancy.uk/news/18324/global-corporates-shifted-616-billion-in-profits-to-11-tax-havens

When it comes to transferring profits, the United States of America is the leading country, where those profits reach 142 billion dollars. The United Kingdom takes the second place with 61 billion dollars, and the third place is taken by Germany with 55 billion dollars. It is estimated that tax havens may be home to even 21 trillions of dollars and most of that money is beyond the tax collectors' reach. First instances of transferring profits to tax havens have been observed in the 90s and they were estimated to encompass from 5 to 10% of global profits. At the beginning of 2010, those estimates rose to around 25 to 30% and up to this point they are enormous budgetary losses for the concerned countries.

Polish legal regulations that deal with transfer pricing have been introduced in 01.01.2019 and were based on the so-called ATAD directive (the Directive 2016/1164 of EU Council of 12 July 2016) which set down regulations that are supposed to prevent tax avoidance practices. Those regulations have been named Exit Tax and are reflected in Polish legislation in both Personal Income Tax Act in articles 30da to 30di and in the Corporate Income Tax Act in section 5a, article 24f to 24l. They can be applied in a situation where Poland loses rights to income tax during moving the physical assets of the corporation or a natural person to a different country. It is required for the right to tax to be available even if those assets were not transferred. The introduction of the Exit Tax caused a lot of controversy and was met with the negation of its right to be executed. The jurisprudence of EU's Court of Justice emphasizes repeatedly that this tax cannot clash with the principle of the freedom of establishment described in the article 49 of the Treaty on the Functioning of the European Union (later referred to as TFEU). Moreover, the preamble to this directive and articles 1 to 3 thereof clearly point out the fact that this directive does not apply to persons who are not subject to legal person tax, meaning that it does not apply to physical persons; despite that, Polish legislation included physical persons and

imposed restrictions on them, thus performing an incorrect implementation of the aforementioned directive [Mariański 2019: 30]. It does not mean that the legislator should reject taxing physical persons with exit tax a priori but adopted approach may be incompatible with EU's law [Nowak-Piechota 2019: 39]. Transaction prices were also described in article 3 point 10 of Polish Tax Code; according to it "...the transaction price is defined as the price of the object of a transaction between related parties, within the meaning of the provisions of the act on personal income tax, corporate income tax, as well as goods and services tax". However, this legislation is of a protective nature rather toward the taxable person.

The pioneer if it comes to creating legislation concerning transfer pricing is OECD. OECD Guidelines for Multinational Corporation and Tax Administrations are the basis for creating the standards of conduct in many countries; sometimes, they are even a part of the country's legal order. The first edition of Guidelines was published in 1995 and the latest version was published in 2017. The results of working on the Base Erosion and Profit Shifting (BEPS) project were shared back then. The project dealt with tax base erosion and profit shifting if it comes to tax evasion or tax avoidance. In respect of BEPS, a multilateral MLI Convention was established. MLI implemented the means of treaty tax law, which are meant to prevent the tax base erosion and profit shifting; this convention applies without interruption since 1 July 2018 and the project was joined by 115 countries. BEPS was consolidated from all drafts in 2014 and it turned out to be the first groundbreaking achievement of the past 100 years if it comes to taxes. The cooperation in order to coordinate BEPS was guaranteed by OECD and G20 [OECD/G20 2015: 3]; G20 being a group of countries and EU cooperating together if it comes to common fiscal policy. Among the Guidelines, 15 items have been specified which are supposed to combat the immoral policy of transfer pricing through:

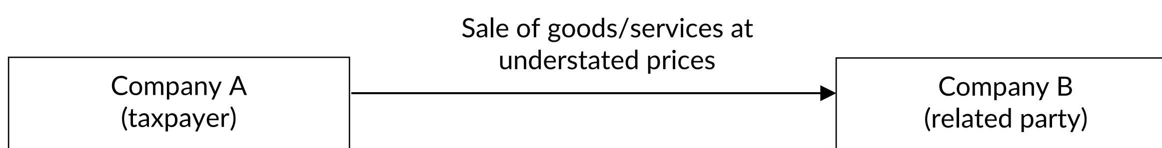
- introducing modified regulations in electronic commerce in respect of the taxes
- introducing CFC rules - taxing foreign controlled subsidiaries or branches
- preventing the abuse of treaty shopping, which will be explained in more detail in the next section
- preventing the abuse of deducting various expenses from the tax base
- compulsory reveal of aggressive taxation strategies [Jaszczuk 2013: 8].

The fight with the dishonesty of taxpayers was undertaken not only by the EU, but also other countries from the outside of EU, such as the United States of America. In 2010, the United States Congress adopted the Foreign Account Tax Compliance Act, later referred to as FATCA, which allowed the American government to estimate the losses attributed to

the applicable taxes of the taxpayers who possess financial investments outside the territory of the USA. Since the introduction of this act, American taxpayers have been obliged to submit Internal Revenue Service which is a declaration about the funds that they possess abroad. FATCA also concerned foreign institutions, such as banks, broker companies and insurance companies [Jaszczuk 2013: 9].

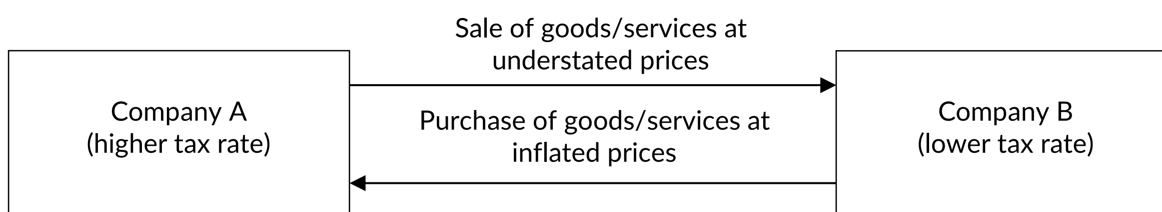
If it comes to tax optimisation, many considerable benefits can be achieved while making use of transfer pricing, for example the minimisation of tax and customs duties [Barowicz 2009: 79]. In order to achieve the intended effects, capital groups use profit transfer; it is a situation when a company with headquarters in a country with a high level taxation sells goods or services to a subsidiary located in a tax haven. The price of such a sale is undercut so that the company in a tax haven can increase it during the further sale on the market and, in this way, combine the revenue in a country that has an attractive tax system. Profit transfer can also be conducted through artificial inflation of the expenses. The company from the tax haven can provide incredibly expensive services to a company located in a country with a high tax regime, which will tremendously influence its expenses, and those expenses will further influence the tax [Toborek-Mazur 2010: 60-61]. Leading up to a certain transaction between related parties can cause the increase or decrease of loss. It can also contribute to the increase or decrease of revenue, as well as lowering or completely reducing the tax [Marciniuk 2002: 151]. The above description can be easily illustrated by the use of two diagrams:

Figure 3. Reducing tax charges by selling goods/services to a related party



Source: Author's own elaboration.

Figure 4. Transferring prices between related parties located in different tax regimes



Source: Author's own elaboration.

The manipulation of transfer pricing influences financial statements of related parties. Sometimes, a comprehensive and factual assessment of the financial situation of a certain company is difficult or even impossible. This situation is influenced by the function which transfer pricing fulfill in a certain company. Undoubtedly, they allow to obtain immeasurable financial profits, but only if they are viewed through the lens of the whole undertaking and not from the perspective of only one branch [Witczak 2008: 17].

Depending on the needs of a certain capital group, one can influence serious endeavours through this process, such as: creating an illusion that a subsidiary does not generate income, which could justify closing the subsidiary; artificially lowering the revenue, which causes the lowering of employees' salaries if they are dependent on the revenue and, in turn, leads to creating the lowest amount of expenses for the company; or receiving a decision of the national government awaited by the company, for example needed in order to achieve the tax relief, through showing certain data in the financial statement or obtaining additional sources of investment, such as acquiring investors or getting a bank loan, which can be tremendously influenced by artificially over-declaring the revenue of a branch [Kabalski 2001: 16]. From an ethical point of view, a positive aspect of a company's transfer pricing may be that by maximizing profits, it will be able to better reward its employees and create many new jobs [McGee 2010: 11].

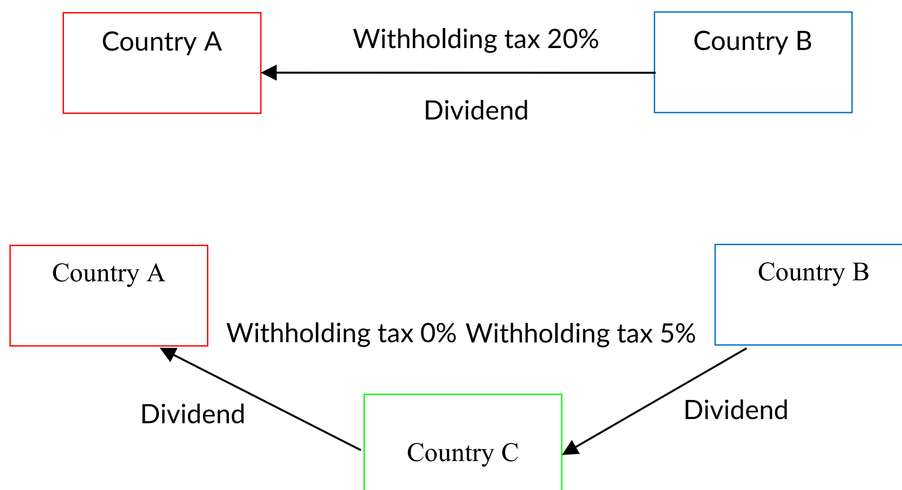
4. Treaty shopping

This phenomenon is strictly connected with double taxation agreements. The term alone is a reference to an expression used in the United States of America which is forum shopping [Avi-Yonah and Panayi 2010: 2] and it means that a citizen has the right to choose the court that will provide them with the most favourable sentence. Over the years, numerous definitions of this phenomenon have emerged, but the most popular one has appeared in the International Bureau of Fiscal Documentation and describes a situation in which an unauthorized entity benefits from the privileges being the result of double tax agreements. In order to make use of such a method, one has to establish a company in the third country, which will enable them with the authorization to benefit from the tax benefits [Zdyb 2007: 16].

Using treaty shopping for the purposes of tax optimisation is a legal endeavour, but one that is undesirable in many countries. OECD defines it as an inappropriate way of using double taxation agreements. Establishing an entity in a tax haven is of legal character, but without that procedure, the beneficiary would not receive any benefits [OECD 2015: R (6)-

2]. According to the works on this subject, one cannot state clearly that conducting such a procedure is synonymous with abusing the law. Avoiding being taxed by using this method is a less risky and more effective action that trying to achieve this goal by limiting yourself to operating within the borders of a single country [Poleszczuk 2000: 55]. It is easy to understand how effortless it is to conduct this method once a diagram is introduced.

Figure 5. A diagram of how treaty shopping works



Source: Zdyb 2007: 18.

Country C on the diagram above is simply a company established in the third country, which makes it possible for the other two companies to receive tax benefits.

Even though the previously elaborated on method of tax optimisation is legal, the techniques of achieving it differ from one other and tax law can be abused, if it comes to different techniques [Zdyb 2009: 29]. Among the legal techniques one can enumerate:

- direct conduit method - a conduit company is established and the method is introduced when a company invests capital in a different country and no double taxation agreement is signed between the country it is located in and the country that it invests in (or the agreement is signed, but it does not offer benefits for the interested parties). Lack of such an agreement can lead to high tax claims. That is why establishing a conduit company takes place in a country that signed such contracts both with the country where the investing company is located and the country where the investment is located. It allows to transfer profits in such a way that there will be no taxation at all, or it will be relatively low and profitable [Vogel 1997: 532];

- stepping stone method - a technique quite similar to the previous one, because establishing one or even two conduit companies also takes place. It is vital for the fourth company to be located in a specific country. In the said country, the double taxation agreement is signed with another country (the one where the investment is supposed to take place) on more beneficial terms. A significant difference between the first and the second technique is that the achieved goal is different. The first method leads to the reduction of tax burden, while the stepping stone method is supposed to reduce the fiscal responsibility because balancing out the expenses in those companies will occur [Wyciślok 2006: 17];
- back to back loan is used to transfer interest from the loans between the related parties. Thanks to this technique, transferring income to another country is possible almost cost-free because of certain provisions in the double tax agreement which allow one to be exempt from the tax [Zdyb 2007: 18];
- holding structures - apart from double tax agreements, they also allude to internal regulations when there is a situation in which there is no taxation at the source; it is called participation exemption. Holding companies that are used in this case and fulfill certain requirements, can make use of participation exemption [Zdyb 2007: 19].

As it was mentioned earlier, there are also illegal techniques aimed at achieving treaty shopping. These are:

- dual residence - the company that is ought to receive a dividend seemingly changes the country of its residence for the same one as the company that ought to pay it. Such a manoeuvre is supposed to assure a certain tax benefit which makes it illegal in the eyes of law and results in violation of fiscal law [Gajewski 2011: 8D];
- transfer of tax residence - a phenomenon that is similar to the one above. An entity that wants to sell its shares in a company being tax resident of the country that the said company is in, and one that wants to avoid taxation, transfers their tax residence to a country with favourable tax regime and in this way performs an optimization. In both cases, it cannot be assumed that such actions are dictated by economic goals. Their only aim is transferring, according to the needs of a tax domicile [Zdyb 2007: 20];
- triangular transactions - they use institutions the foreign revenues of which are not taxed. In such a structure, these revenues would be coming from a tax haven, however, the chief company, the owner of the institution, would be obliged to acquire the residency in a country which does not tax institutions under the double

taxation agreements. In the presented scenario an erosion of tax bases would definitely occur, which was not the goal of the countries, with the obvious exception of a tax haven [Zdyb 2007: 20];

- rule shopping - it is a change of the revenue's character into a one that, on the basis of double taxation agreements, is more profitable; therefore, it is subject to a lower tax rate. In this technique, one can distinguish certain conversions of the revenue which happen with the use of the proper transaction's structure. These are conversions of the revenue coming from property into revenue coming from the selling of shares, as well as the conversion of dividends into capital gains and the conversion of dividends into interest. Derivative transactions (secondary transactions) are also a part of rule shopping. In most part, they refer to interest and capital gain, and are based on the formal character of the revenue and using the tax preferences stemming from double taxation agreements. They reach the same goal as transactions in which the economic effect prevails over the legal form [Lombardi and Rotondaro 1998: 133];
- shifting to lower tax bracket - this technique can be used only if a given double taxation agreement predicts two different tax rates for one type of income. In this situation a manipulation of the transaction takes place that would allow the income to fall within the lower rate. This phenomenon can take place, for example during the withdrawal of a dividend. Before the withdrawal, the shareholder can increase their shares in the capital of the company which is supposed to withdraw the dividend and at the same time profit from certain tax benefits [Gajewski 2011: 8-D];
- dilution or splitting - this technique is performed through the reduction of the tax base in the country that is the source of income. This method is used for example in transactions of real estate property sales. For tax purposes, such property can be divided into parts which, in the eyes of law and because of their value, will not be subject to taxation. The only goal of such a division is gaining profit, which is why this action is considered a fraud [Zalasiński 2008: 20].

In order to distinguish legal treaty shopping techniques from the illegal ones, the latter ones are described as treaty abuse [Zdyb 2007: 16].

Extremely helpful while fighting the phenomenon of treaty shopping is the OECD's Model Convention which contains the clues that are supposed to help the member states in eliminating treaty shopping. Within its framework, one can distinguish the following possibilities:

- the look - through approach - it refers to intermediate companies and its goal is the restriction of tax benefits for such companies that are not the property of the resident of a country in which they were set [HJI Panayi 2007: 46];
- the exclusion approach - it forbids the use of tax benefits by the taxpayers who would achieve them thanks to setting up a tax-exempt company based on double taxation agreement, if it were to be its only intended purpose [Gajewski 2011: 9-D];
- the subject - to tax approach - source country can grant tax benefits, but only providing that the income is subject to taxation in the country of residence. The substance of this case is that the possible benefits are granted not in one, but in a few countries [Bernstein 2007: 1212-1213];
- the channel approach - the taxpayer should not be eligible for benefits if they cumulatively meet present conditions: gets an income from an another contracting state, at least one person in this company exercises direct control and is not a resident of any other country, and at least 50% of the company's revenue settles the claims of this person [Wyciślok 2006: 17-18].

BEPS in its report suggests that in order to avoid abuse of the treaty benefits arising from art. 10 of the OECD Model Convention, reduced rates should only apply to residents who have lived in the country for at least 365 days [Duff 2018: 956]. All above clues apply to legal persons, however, one can distinguish a different method which appeals to natural persons, namely recording revenue to a chosen entity or person. This concerns mainly athletes and artists, because their income can be withdrawn not directly to them but to the companies who employ them. Ultimately, it comes to the fact that the place of taxation of such natural persons is changed [Głuchowski 1996: 154-155]. However, this is rarely used because the tax residence of individuals is usually dependent on their place of residence and the center of social relations [Duff 2010: 3]. It is understandable why treaty shopping is viewed negatively in the context of tax optimisation, however, a broader view, for example in respect of macroeconomics, can reveal its positive impact on the economic development of some countries but here are voices in favor of making the doctrine more stringent for taxpayers who abuse rights. For example, Weeghel gives three reasons why national doctrine to combat the phenomenon of treaty shopping should only be used in conjunction with international law [Elliffe 2016: 84].

5. Conclusions

There is no doubt that not all tax optimisation practices abuse the legal provisions. Thanks to economic freedom and the global openness of countries' borders, businessmen can decide where the headquarters of their company are and, in a way, where the centre of their business will be located and why. Deeming all practices in which tax havens play an illegal role could cause an infringement of the privileges mentioned above, which, in times of democracy, would spark controversy and cause complications for the countries' leaders, even if it comes to the economic background.

In the upcoming years, the scale of this phenomenon will definitely not change and one can assume that with confidence because of its history. People have been trying to minimise what the country was imposing on them since the ancient times. One of the examples could be the Rhodes Island; it was viewed as a tax haven in the 6th century BC, and that period was not a time of freedom and globalisation. Low tax regimes are extremely popular and that is why they will never stop being a global "issue"; what will change, though, are only the only the practical ways of performing such procedures.

The only solution that could stop people from using tax havens would be reducing the tax burdens in all existing countries, to the point where transferring tax residence would stop being profitable to the businessmen. For obvious reasons, it is never going to happen, but it would lead to a complete disappearance of tax havens. Instead of such a situation, one is going to witness the increase of using tax havens since new companies keep being established. This increase will not be permanent, because it will eventually be limited by national and global legislation meant to efficiently prevent enjoying the tax benefits if the activities of the operator extend beyond the borders of the said tax haven.

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