

# The impact of tax havens on business decision-making

[Economics](#), [Tax](#)



## Introduction

OECD's initiatives have exemplified that tax havens have attracted more and more attention in recent years (OECD, 1998, 2000, 2004). Compared with nonhaven countries, tax havens have lower levels of corruption, better political and legal systems, and that they could defer or reduce tax liabilities to other countries through strategic use of debt among subsidiaries or transfer prices strategy. A 100% owned abroad subsidiary of a multinational company (MNC) can manipulate their interests, management fees, transfer prices and royalties charges, which can cause the subsidiary to avoid some tax payments in home country.

Generally, a MNC could minimize taxable income arising in high tax countries, increase investments in low tax countries to reduce the average tax rate on their profits, or in order to delay the investment income from high tax jurisdictions, they could keep these earnings in a very low-tax country before they are used (Miller and Oats, 2009). If firms can get low tax rates abroad, they may not bring themoneyback to their home countries which have high tax rate, as a result, when the MNC recycles its foreign profits arising abroad, these earnings could be exempted from being retained earnings or foreign borrowings. Tax havens could be used as a means to protect portfolio gains from foreign direct investment profits. This is mainly because the infrastructure in tax havens is much more suitable to mobile portfolio income. This paper through analyzing three aspects of tax havens: its characteristics; its role in international market; the practical uses, mainly explains the impact of tax havens on business decision-making.

## Characteristics of Tax Havens

Actually, the definition of tax havens still hasn't been defined standard.

Typically, in tax havens foreign investors can enjoy very favorable tax regimes, such as low or nil withholding tax rates or corporate tax rates on all or certain categories of income. In recent years, although the national tax group shares more and more kinds of information, another feature of tax havens – bank or commercial secrecy laws – is still very significant.

Tax havens are low-tax jurisdictions, and in these areas investors have opportunities to get tax avoidance. No matter in what shape or form of tax havens, these countries and jurisdictions try to gain competitive advantages in commercial competitions through their particular tax systems. These tax havens are often recognized as offshore financial centers, which usually means “ any shifting of funds out of the country of taxpayer residence for tax planning or tax evasion purposes” (Miller and Oats, 2009, p226). In offshore financial centers transactions with non-residents often exceed the related domestic transactions to a large extent (Dixon 2001, as cited in Miller and Oats, 2009, p225). These offshore financial centers normally have favorable regulatory system, legal environment and tax regime; MNCs perhaps adopt new financial products quickly and flexibly in the favorable legal environment.

Dharmapala and Hines (2006) illustrate some characteristics of tax havens compared with nonhavens. In general, tax havens countries or territories are virtually wealthier than nonhavens. They usually have smaller population size, and their geographical characteristics are more likely to be islands with

scarce natural resources, which can easily lead to economic openness. They also have substantial differences from nonhavens in legal origins and political institutions. Typically, tax havens have stronger governance institutions than comparable non-haven countries, and they are more likely to be dependent territories, have better legal and political systems. The examples of tax havens jurisdictions include Hong Kong and Singapore in Asia, Luxembourg and Ireland in Europe, and some Caribbean island nations in the Americas, and that within some countries there are also low-tax jurisdictions, for example special economic regions in China.

The Gordon Report, prepared for the US Treasury in 1981, states some more characteristics of tax havens. Income and capital in tax havens countries usually can get lower or zero tax rate and banking or commercial secrecy provides some opportunities to tax avoidance and/or tax evasion. There is no exchange control, but it provides a provision of offshore banking facilities. Additionally, tax havens often have good communication facilities and political stability; they can provide an opportunity for multilateral tax planning. Foreign capital in these countries can get favorable disposition; professional advisers are always available for foreign investors. Furthermore, their convenient locations and decent communications climates, especially the freedom from excessive regulations,

## **The Role of Tax Havens in International Market**

There is a traditional “ negative” view that tax havens play a disproportionate role in the world’s foreign direct investment (FDI) (Slemrod and Wilson, 2006), however, an emerging “ positive” opinion of havens

implies that their existence may not make high-tax countries get worse (Hines, 2006, 2007; Hong and Smart, 2007). High-tax countries may tax immobile firms more heavily, but tax havens impose lower tax rates on highly mobile firms. Given all other considerations equal, tax policies can affect MNCs' FDI; lower tax rates could increase after-tax returns, thereby increasing investment funds. Generally, tax havens don't have the responsibilities to provide the same function for all MNCs. The larger tax haven jurisdictions are (given the sizes of local economies), the greater opportunities taxpayers have to locate taxable profits.

The same investment activities in countries with different tax rates may get very different opportunities for tax avoidance. MNCs can achieve tax avoidance in various manners, such as intrafirm trade, dividend repatriations, royalty payments, and intrafirm debt. Many enterprises use transfer prices within business transactions to reduce their overall tax burden, in fact, this approach is being widely suspected. MNCs typically can obtain certain benefits from allowing affiliates in high-tax countries to reduce the prices of goods and services provided to affiliates in low-tax countries. Transfer prices may be paid by groups not related to these transactions, however, when pricing issues relate to some special proprietary and differentiation provisions, this situation is getting to be quite complicated. Because of some legal looseness firms completely can adjust transfer prices without violating any laws.

According to Hines and Rice (1994), tax havens can be used by MNCs to gain profits away from high-tax countries, but can also help to repatriate taxes

from activities in low-tax jurisdictions. For mitigating double taxation a country can provide some credits to MNCs and use deferral policies before profits are repatriated. As a result, this approach may increase this country's tax liabilities when repatriating profits earned in low-tax jurisdictions.

Altshuler and Grubert (2003) state that through kinds of ownership arrangements tax havens can make deferral of repatriation taxes available.

## **Practical Uses of Tax Havens**

A former employee of a Liechtenstein bank sold business information to Germany's tax authorities, in February 2008 this international scandal was exposed. This news made some German residents being prosecuted for tax evasion, and meanwhile it attracted tax havens' more attention on tax evasion issues, because some individuals use tax havens to avoid home country taxes illegally. Countries with income tax systems tax their residents' overseas earnings, such as the interest, dividends and capital gains, whereas tax payers can evade these taxes because of some loopholds in bank secrecy laws. If foreign individuals don't report their income arising in tax havens countries to their home country, their home country won't know this income, because bank secrecy in tax haven countries will not provide information about these earnings to home country (Desai, Foley and Hines, 2004).

As a general matter, individuals' use of havens can be evaluated by foreign portfolio investment (FPI). International portfolio diversification provides insurance against the economic risks from investor's home country, so investors can get substantial gains (French and Poterba, 1991). Investors

have many nontax advantages for international diversification in tax havens, whereas they have to spend some efficiency costs on the benefits of FPI. For the purpose of evasion more and more investors locate their portfolios abroad, however, the issues of fairness and confidence in the tax system is undermined (Desai, Foley and Hines, 2006a). The costs caused by individuals' use of tax havens largely depend on the degree of tax evasion. Some significant amounts of revenues are lost by countries as a result of illegal tax evasion through havens.

Firms also invest large amounts in tax havens, but the firms using of havens may be quite different from individuals. The firms, which prefer to operate in tax havens, are most active abroad, technology-intensive and with extensive intrafirm trade, and these firms always are large MNCs. In order to get tax avoidance in tax haven operations, these firms could allocate taxable income away from high-tax jurisdictions. In larger tax haven jurisdictions the firms primarily reallocate taxable income, whereas in smaller tax haven countries the primary use of these firms is to facilitate deferral of home country taxation of foreign income. If a tax haven operation could generate a 1.5 to two percent greater sales and investment growth, in non-haven countries it's only one percent greater likelihood (Desai, Foley and Hines, 2006b).

Generally, these firms are not seeking to evade home country corporate taxes; they use tax havens for getting tax planning activities and tax avoidance legally.

MNCs can use havens to defer or reduce their tax liabilities to other governments. Most nonhaven countries have two approaches to taxing their

resident corporations' overseas income: a "worldwide" system (used by the US, the UK and Japan) provides a foreign tax credit (FTC) for taxes paid to foreign governments to avoid the double taxation; a "territorial" system (used by most capital exporting countries, such as Germany and the Netherlands) exempts abroad income from home country taxation (Hong and Smart, 2007). For MNCs in territorial countries, income from the home country or some other high-tax country could be reallocated to a tax haven. Actually, a worldwide system is not pure, for example the US allows the taxation of overseas earnings to be deferred until these earnings are "repatriated" to the US. Moreover, the tax paid to the tax haven government is low or nil, thus, MNCs based in countries prefer to use tax havens to reduce or defer their tax liabilities, and they can use of debt among affiliates and transfer pricing to achieve this aim.

When subsidiaries of a MNC trade between themselves, the prices they used can affect the allocation of the MNCs' income within different jurisdictions. Governments generally ask firms to use "arm's-length" prices; however, arm's-length markets may don't exist for some transactions. Take intellectual property for example, subsidiaries of same MNC can choose the place to locate research and development activities in order to attract other subsidiaries' royalty payments into lower-tax countries; or MNCs can also have affiliates in tax havens lend to affiliates in high-tax jurisdictions. This "interest stripping" or "earnings stripping" generates interest deductions in high-tax jurisdictions and makes interest payments flowing towards low-tax jurisdictions (Desai and Dharmapala, 2006). Though governments impose



some restrictions on capital structure to restrict this situation, apparently it's less successful.

## Conclusion

In many countries the governments make policies to reduce the tax burden of their residents, but they cannot make people avoid taxes totally. If the exemption method of taxation is used simply, the residents may pay nothing on their income arising in a tax haven country. Thus, there is a limited relief on the income from tax haven countries. The firms in tax haven countries could reallocate taxable income earned in high-tax jurisdictions and defer repatriation taxes on income from low-tax jurisdictions. Operations of MNCs in tax haven countries can be treated as part of their international tax avoidance strategies. Tax havens usually attract MNCs to establish affiliates there, and high R&D industries and intrafirm trades with large volumes prefer to invest there as well. Presumably, larger tax haven countries are likely more suitable for subsidiaries to reallocate income, and to reflect the effects of transfer pricing enforcement. Apparently, firms investing abroad at faster rates are more likely to establish new tax haven operations to avoid taxes.

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