Fiscal Paradise

or

Tax on Development?

What is the role of the tax haven?

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tax justice network

Summary

This report shows that there are at least 72 tax havens in the world.

It has been estimated that up to half of world trade might be routed through tax havens. Recent evidence suggests that almost no developing country has the means to regulate the abuse of this trade through artificial transfer pricing. Locating these transactions in a tax haven makes them very difficult to challenge. The result is that the tax base of developing countries is regularly undermined, at direct cost to their governments.

So much cash has fled offshore through the process known as capital flight, much of it from developing countries, that it is now estimated that trillions of dollars are at least notionally held in offshore accounts. It stays there to avoid tax and to ensure that the dubious claim to ownership that many of the registered owners have to that money is not challenged. Much of this money should be used instead to finance development in the countries from which it fled.

The secrecy space that tax havens provide encourages corruption, and it is widely accepted that this is more likely to happen in developing countries. That corruption is now being cited as a reason to stop funding development assistance.

It is hard to say with certainty how much these actions cost developing countries a year, but this report highlights that estimates of up to $600 billion a year have been put forward. That is 12 times the annual sum needed to meet the Millennium Development Goals.

The conclusion from these findings is inevitable. Tax havens are not a fiscal paradise. They are the home of anti social and illegal activity that hits the poor of the world hardest of all.

Action could be taken about this. The UN, World Bank, IMF, EU and OECD all have much to gain from tackling this issue, but need to do so in a more concerted fashion.

Big business could be regulated by the creation of improved accounting standards to show who is doing what offshore. In addition, improved and more transparent accounting standards could do much to help developing countries access the information they need to charge appropriate taxes. This would help ensure those countries can retain within their economies the profits and tax revenues that are vital to their development by removing the incentive for them to be taken offshore.

Multinational business could be taxed on an international and not national basis, so closing very many of the

loopholes which it now exploits.

Governments could change their approach to taxation law to make exploitation of loopholes harder. And the process of automatic information exchange which the EU has pioneered could, and should be extended internationally, and should carry economic sanctions if not offered by any country.

If the world is serious about:

- development;
- the relief of poverty;
- fair trade;
- the war on terror;
- transparency; and
- the elimination of corruption

then the proposals made in this report will go a long way to solving its problems.

All that is required is the political will to make this happen.

About the Tax Justice Network

The Tax Justice Network is a non-aligned coalition. It is made up of:

- development agencies;
- faith groups;
- trade unions;
- academics;
- journalists;
- economists;
- financial professionals, and
- public-interest groups.

They share their concern about the social and economic impact of:

- tax avoidance;
- harmful tax competition; and
- offshore financial centres.

The TJN was founded in 2003. Its launch followed on from meetings at the first European Social Forum in Florence, and the World Social Forum at Porto Alegre.

The people who attended those meeting were concerned about issues raised in a report issued by Oxfam in June 2000. This highlighted the impact of tax avoidance, banking secrecy and tax havens on developing countries. It also raised concerns about the cost to poorer countries of having to engage in tax competition to attract inwards investment.

Through its network the TJN aims to identify the deficiencies of national and international tax policies. As importantly, it aims to suggest remedies for them.

The Tax Justice Network does not intend to replicate the work of existing campaigns that are engaged in promoting tax justice in some countries. Instead it seeks to connect those campaigns to a growing worldwide movement. By doing so it hopes to:

- promote more local campaigns for tax justice, especially in developing countries;
- provide a medium through which tax justice issues can be promoted within multilateral agencies such as the United Nations, the World Bank, the International Monetary Fund, the Organisation for Economic Cooperation & Development, and the European

Union.

By operating at this level the Tax Justice Network specifically seeks to counteract the influence of legal and accounting organisations that devote a huge resource of time and money to lobbying on behalf of business and wealthy individuals for favourable tax treatment.

Since its launch, the Tax Justice Network has:

- organised two international workshops that have attracted participants from countries on five continents;
- been launched in many leading countries, including Austria, Belgium, Finland, Germany, Switzerland and the United Kingdom;
- engaged with senior personnel from the OECD and the World Bank,
- advised on reform to the international Extractive Industries Transparency Initiative;
- participated at the most recent meetings of the United Nations ad hoc group of experts on international tax matters, held in Geneva, Switzerland in December 2003, where it was the only accredited civil society organisation to do so.

The Network:

- is directed by an International Steering Committee elected from its membership around the world;
- has an advisory committee of legal, economic and tax specialists to guide its research activities and advise on policy issues;
- has an International Secretariat based at the New Economics Foundation in London.

The international working language of the Network is English.

For more information visit the Network website at www.taxjustice.net

About Tax Research

This paper has been written by Richard Murphy, the director of Tax Research Limited. He is senior tax adviser to the Tax Justice Network.

Tax Research Limited is an independent company researching tax issues, largely as they relate to tax justice, development and the relief of poverty.

Richard Murphy is a UK chartered accountant. He has over 20 years experience of tax practice and was senior partner of a UK firm of accountants for 11 years. He has also been chairman, chief executive or finance director of 10 UK and overseas companies. He is an active writer and journalist and has worked for, amongst others, the Observer and BBC. He is contributing editor of AccountingWEB.co.uk, the largest UK accounting web site and is a visiting fellow at the Centre for Global Political Economy at the University of Sussex.

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Objectives of this report

This report has five objectives:

1. to say, very briefly, what a tax haven is;
2. to explain why people use tax havens;
3. to show why this is harmful to development;
4. to estimate the scale of the problem for developing countries;
5. to suggest ways in which the problem can be tackled.

What is a tax haven?

There are a whole range of definitions available for tax havens but the following, based on that produced by the OECD is reasonably broad based:

1. non-residents undertaking activities in the haven pay little or no tax;
2. it has no effective exchange of taxation information with other countries;
3. its activities and those of the organisations based there lack transparency;
4. it seeks to attract investment which requires no substantial commercial activity to take place.

Not all of these need to apply for a territory to be a haven, but a majority must.

A list of territories we think are havens is attached as an appendix for those who are interested.

What does no tax on non-residents mean?

All tax havens require income.

Most governments get their income from taxation.

Most governments charge all people, companies and trusts who undertake economic activity in their territory to tax.

Tax havens are different because:

1. they encourage people with no other contact with their territory to:
    a. open bank accounts there;
    b. set up companies there;
    c. operate trusts there.

2. they make sure that while they locate these activities in their haven none of the activities they actually undertake occur in the haven. So:

    a. the bank account is used to receive income earned elsewhere and settle bills incurred somewhere else;
    b. the companies incorporated in the haven must not undertake any real trade there;
    c. the trusts manage assets located elsewhere.

3. on the basis that these bank accounts, companies and trusts don't do anything in the tax haven (except, perhaps pay some official fees and charges) they are exempted from tax there.

In the British Virgin Islands the fees paid by non-resident companies comprise more than half the income of the government.

What does no effective information exchange mean?

It's normal for governments to tell each other, on request, what a citizen or company or trust located in one territory has done in another one.

Within the European Union it is now becoming normal for information on the activities of citizens to be exchanged automatically between tax jurisdictions.

No developing countries currently participate in automatic information exchanges on the activities of their citizens, or with regard to the funds of non- residents deposited there. In many cases tax havens refuse to participate in such arrangements.

At present almost all information exchange arrangements apply only to individuals and do not apply to companies and trusts.

This last point is vital. All serious wealth is held in companies and trusts. For that reason there remains no effective information exchange either from tax havens or between many other countries.

What is a lack of transparency?

This means:

1. banking secrecy is strictly enforced. No bank can say what they are doing for anyone without severe penalties applying;

2. even if a register of companies exists it does not require:

   a. the names of the beneficial owners to be published;
   b. the names of the people who really control the company to be published;
   c. accounts to be put on public record.

3. trusts can be created without:

   a. any authority having to be informed
   b. the names of the settlor or beneficiaries having to be disclosed
   c. any accounts ever being filed with anyone, ever.

In other words, it's almost impossible to find out who is doing what in a tax haven.

What is "no substantial commercial activity"

This means that no real commercial transactions take place within the tax haven.

Anything that is recorded as taking place within the bank accounts, companies and trusts officially recorded as being there actually takes place somewhere else.

So why use a tax haven?

There are only three reasons why anyone would ever use a tax haven:

1. they want to avoid tax;

2. they don't want people to know what they are doing;

3. they want to avoid regulation.

Everything that is done offshore can always be done better onshore but for these three things. So these are the only reason for going there.

What economic activities use tax havens?

Three types of economic activity take place in tax havens:

1. corrupt ones;

2. those seeking to avoid tax;

3. those avoiding regulation.

In most cases these share one feature in common, which is that the person undertaking them does not want someone else to know about them.

What legal businesses use tax havens?

According to LowTax.Net the following businesses are the most common to be located offshore:

- trade marketing and distribution;
- financial holding and investment activities;
- corporate financial and management services;
- offshore banking;
- offshore financial services;
- ship management;
- licensing and franchising royalty collection;
- professional services;
- insurance.

It is obvious that all but the first of these are managing activities undertaken somewhere else. So too is the first once one explores the examples provided by LowTax.Net. They do not suggest a business should really relocate to a tax haven. What they actually suggest is it should try to shift part of its profits there. And that's quite different.

The suggestion that what goes on in a tax haven is just a sham is, therefore, supported even by one of its most enthusiastic supporters on the Net.

What illegal economic activities use tax havens?

Two types illegal activity use tax havens:

1. Corrupt ones. These include:

    a. the receipt of bribes and illegal commissions;
    b. money laundering of all sorts;
    c. drug and people trafficking enterprises.

2. Tax evading ones. These include:

    a. individuals not declaring their income in offshore accounts;
    b. people relying on secrecy to avoid a tax liability;
    c. businesses undertaking dubious practices such as artificial transfer pricing which moves profits from high tax to low tax areas.

What other economic activities use tax havens?

There is one other, very important type of economic activity that uses tax havens. Almost all "capital flight" ends up in tax havens.

Capital flight is the movement of cash and investments out of one country to a place in which they believe the assets will be safe for their use.

Capital flight occurs because the owner of the money involved believes that the cash or assets they hold will be lost to them if they are kept in the country in which they originated for one of three reasons:

1. the political economy of that country is too unstable;

2. the owner should not have had the money in the first place;

3. the owner does not want to pay tax on the money they have received, or the investment income that it will generate.

So are tax havens Fiscal Paradise?

In summary then tax havens do these things:

1. they encourage crime and corruption by providing the secrecy space in which it can happen;

2. they encourage tax evasion by providing a tax free environment in which it can be claimed profits are earned when the real transactions take place elsewhere;

3. they provide a safe home for "capital flight" money that wants to be hidden from prying eyes;

4. they provide a space in which the regulations of the developed economies put in place to protect their citizens from abuse can be avoided by unscrupulous businesses.

In simple terms, this is a place a long way from paradise, however you define it.

Which is not surprising, because as was noted above, there are only three reasons why anyone would ever use a tax haven, and all are anti social.

What has this got to do with development?

It has taken a while to get to this central, critical question. But without understanding tax havens it is not possible to say why they are so harmful to development.

There are three reasons. These are that they encourage:

1. corruption;

2. capital flight;

3. tax avoidance and evasion.

Corruption and development

Between 1970 and 2002 the World Bank and the IMF disbursed

- $232bn to Indonesia;
- $94bn to the Philippines;
- $28bn to Nigeria;
- $10bn to Congo/Zaire.

Transparency International suggest that of these sums up to the following might have been stolen :

- $35bn was stolen by Suharto of Indonesia
- $10bn by Ferdinand Marcos
- $5bn by Sani Abacha of Nigeria
- $5bn by Mobutu Sese Seko of Congo.

In percentage terms these are:

15% by Suharto;
11% by Marcos;
18% by Abacha;
50% by Sese Seko.

Most of this money went offshore. Almost none has been recovered. As can be seen, the sums involve are substantial.

Capital flight and development

No one can be quite sure how much capital flight takes place in the world. That's partly because this money is inextricably linked to funds seeking to avoid tax, and a lot has its source in dubious business practices.

What we do know is that the value of capital flight is substantial.

Raymond Baker suggested in the Financial Times in October 2004 that it might be as much as £500 billion dollars a year from developing countries, a figure he thought ten times greater than the flows resulting from corruption.

Just one Russian oil company (Sibneft) has made dividend payments to offshore trusts of more than $1 billion a year. This is capital flight.

And it shows the scale of the problem. Russia could do with those funds being reinvested in its economy. Instead they are in Chelsea Football Club.

And it's only a small part of the total capital flight from that one country. Between 1995 and 1999 a team in the US estimate that total capital flight from Russia to the US alone might be $8 billion.

It is easy to see how the total figure for capital flight must be very large indeed.

Taxation and development

Tax havens have a direct impact upon development. They do this in three ways:

1. money that should be taxed in the developing country is diverted to a tax haven, often using dubious transfer pricing. In December 2004 a transfer pricing specialist with Deloittes in South Africa was able to write "To date we are not aware of any significant income-tax adjustments relating to transfer pricing in any African country". In this case it is reasonable to assume that this abuse is prevalent. An explanation as to what transfer pricing is can be found in Appendix 2 to this report;

2. investment income that should be taxed in the developing country is shifted to a tax haven and is not taxed there;

3. companies using tax havens pay little or no tax. This has created the expectation on their part that no country outside the developed world should charge them to tax. As a result it has become their habit to demand that they pay little or no tax in the developing countries in which they operate. The result is that many developing countries can only attract inward investment if they offer "tax holidays" to companies who invest in their territories, meaning that those companies pay nothing back to the local economies in which they work. Alternatively developing countries create "tax free export processing zones" in which investing companies can locate, with much the same effect. This process is called "tax competition".

How much does all this cost?

No one can be sure how much all this costs developing countries a year. But we do have some estimates:

1. Raymond Baker thinks corruption and tax evasion cost developing countries about $50 billion a year;

2. he thinks capital flight costs them $500 billion a year;

3. Oxfam in 2000 estimated that tax competition cost developing countries $50 billion a year.

That means total losses might be at least $600 billion a year.

That sum is roughly twelve times the amount of aid that the developing world needs a year to achieve the Millennium Development Goals.

There can be no doubt; tax havens are a tax on development.

What can be done about this?

Thankfully, there is a great deal that can be done about this if there is the political will to do so. Some of the possibilities are:

1. international agencies need to cooperate in tackling this problem;

2. international business has to be considerably more open about where and how it undertakes its business;

3. international companies need to be taxed on an international basis;

4. all governments should be encouraged to introduce general anti avoidance principles into their taxation codes;

5. governments that do not agree to automatic information exchange for taxation purposes should be denied other forms of international cooperation;

all cash flows into and out of tax havens should be reportable by all banks to the money laundering authorities in the countries in which their parent company is incorporated, who should then report them to the host country in which they originate.

International agencies

There are at least five agencies that have a duty to do more to tackle this problem:

OECD

The OECD has played a big part in the attack on tax havens. It could do more though. In particular it could:

- stop promoting tax competition. There is no evidence it works;
- extend its demands for information exchange to companies and trusts as well as to individuals;
- embrace the role of the United Nations in this area, instead of objecting to the UN having a role;
- change its standard double tax treaties to give more rights of enquiry to developing countries.

The IMF

The IMF has undertaken valuable work in suggesting better regulation of government activity to encourage:

- fiscal (i.e. taxation raising and spending) transparency;
- anti money laundering measures.

These are to be welcomed. But if the IMF is to achieve its objectives it has to recognise that government is only half of the equation in regulation. The other half is the private sector. As a result the IMF now needs to extend its expectation of regulation to ensure that:

- all countries maintain a publicly available and free to access register of companies;
- all companies and similar incorporated or legally constituted bodies, such as trusts, are required to file their annual accounts (which must be audited if their turnover is above predetermined limits) on public record on that register of companies;
- the use of nominee directors and shareholders for all companies must be banned as an anti money laundering requirement with incidental taxation benefits;
- the use of trusts without the identity of settlors and beneficiaries being disclosed must be banned for the same reasons;
- all entities required to publish accounts must do so in accordance with the requirements of International Financial Reporting Standards unless they operate in a US controlled territory when US standards may apply;
- the issue of capital flight has to be one that it takes seriously, and seeks to address.

The World Bank

The World Bank is often used as a partner to ensure companies can extract profits from investments in developing countries without tax being deducted at source. This is a practice that it must stop. It undermines the taxation revenues of developing countries.

In addition, the World bank must require that the partners in whom it invests account fully and transparently for all taxes that they owe in the countries in which they make their profits. It has a duty to promote such standards of conduct.

The United Nations

The UN has a key role to play in tackling the taxation issues that affect developing countries.

All developing countries are members of the UN. They are not all members of the OECD which currently takes the lead on many inter-governmental taxation issues.

The UN has upgraded the status of its only taxation committee recently. It needs to have the courage to promote this as a political and not as a technical committee, and to develop it is an embryonic world tax authority in the making, because that, ultimately, it what is required tackle this problem. Only the UN has both the authority and credibility to achieve this.

The European Union

The European Union has made useful progress on some issues concerning tax evasion and the taxation of flight capital. But it could do more:

- the European Savings Directive needs to be extended to companies, trusts and other such arrangements;
- corporate taxation is collapsing in Europe as each nation state finds that its own laws are deemed a breach of human rights under EU law for reason of discriminating in some way when compared with the laws of other EU countries. If corporate taxation is to survive in Europe, as it must, then the EU most promote a common tax base for all European companies, and a unitary basis of profit apportionment to the member states in which income is earned, so ensuring that an effective tax base remains;
- the EU has to continue its work to promote transparency in corporate reporting;
- the EU has to take steps to prevent flight capital using its financial centres. This includes the possibility of requiring deduction of tax at source from funds held in the EU originating from outside it;
- The EU has to be tougher on its member countries with responsibility for tax havens or who act as such (see Appendix 2 for details of those that do). Some of the European mainland tax havens are amongst the most recalcitrant and need to have sanctions imposed upon them if they do not comply with reasonable standards of conduct.

International business – the time to come clean

International business created much of the tax haven structure which is now being used to undermine development. The banks, lawyers and accountants who work in these territories are largely owned by or are associated with major partnerships and corporations located in the EU or the USA. This only happens because they profit from using these arrangements.

This might have been acceptable at a time when it was felt that corporations only owed a duty to their shareholders. Very few people now think that to be the case. In the era of corporate social responsibility it is now widely recognised that corporations have a duty to a wide range of stakeholders. Over the last couple of years it has been recognised that the citizens of a country in which a company operates are together stakeholders of business through the relationships between those business and the government which represents them. In that case a company has a duty to pay its proper taxes as one of its CSR requirements.

Recognition of an issue is one thing, and enforcement of it is another. Just as the duty of a company to pay tax has been recognised so has the practice of "aggressive tax avoidance" appeared to increase. This comprises the following types of practice:

- use of increasingly esoteric tax loopholes to avoid tax when it is known that such action is contrary to the will of the parliament that introduced the tax legislation, and the action to use the loophole cannot itself be guaranteed to be legal;
- an increased willingness to use offshore tax havens to avoid tax. For example, the profits of foreign subsidiaries of US Corporations in 18 tax havens increased from £88 billion in 1999 to $149 billion in 2002 when the total profits of all US multinational overseas subsidiaries were $255 billion. The profits arising in tax havens far exceed their share of the economic activity taking place in those havens, suggesting deliberate manipulation of profit reporting to ensure they are declared in low tax zones;
- the routing of international trade as a matter of course through tax havens. The OECD has estimated that 60% of world trade takes place between multinational companies. More than half of this is thought to take place through tax havens;
- use of schemes to avoid paying taxes before profit is calculated. This is particularly focussed upon attempts to avoid payroll taxes by increased use of outsourcing, sub contracting and esoteric payment mechanisms, especially for highly paid employees;
- attempts to use tax havens to avoid sales taxes and VAT e.g. by supplying internet based services from locations outside the EU.

These actions have become so significant that the combined taxation services of the USA, UK, Australia and Canada have set up a joint task force to tackle them, which is an exceptional and welcome move. Such a step is necessary to tackle the pervasive attitude of those in the tax avoidance industry, perhaps best summarised by a UK accountant who told the press in March 2003 "no matter what legislation is in place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken."

In the face of such attitudes on the part of some businesses those who wish to abide by both the letter and spirit of the law are penalised by appearing to under-perform the market. This is unacceptable but is a situation that exists because there is a lack of transparency about tax in the corporate world. At present companies are only required to report quite basic information about the tax they might be liable to pay, and are not required to disclose where or why it is due. In addition, because group companies present their shareholders with consolidated accounts which do not show in which countries they made their profits or paid their taxes, and how these two relate to each other the whole subject of tax in corporate accounts is a mystery to almost all investors, and their professional advisors.

To tackle this issue a new international accounting standard is needed that shows:

1. where a company has subsidiaries;
2. what they are called;
3. what level of sales they have, both to third parties and within their group;
4. what level of purchases they have from third parties and within their groups;
5. how much profit they declare;
6. how much tax they pay.

If this were done it would be obvious:

1. who is setting up subsidiaries and artificial inter group transactions to avoid tax;
2. who is transferring the profits out of the developing countries in which they work, thereby denying taxation income to their governments;
3. which companies are using and abusing tax havens;
4. who is shifting their profits to avoid paying their taxes.

This would then provide the information to challenge those companies who are abusing the tax systems of the world, and who are using tax havens to do so. The result could be increased tax yields to pay for development.

Tax international companies on an international basis

International companies have driven globalisation. We are not opposed to globalisation. International trade has almost always brought benefits to the people of the world. But there are problems when global companies are not held to account globally.

There is a fiction at play in the tax world at the moment. That is that global companies do not exist. That is because, as a matter of fact, very few such companies do exist in law even though we can all name lots of them in practice. That is because in law they are made up of myriads of interlocking, commonly owned companies, each of which for legal purposes is separate and distinct from all the other companies in their group, and each of which might have a different country in which it is located and taxed. This is of tremendous advantage to those who own and manage these companies. As has been shown in the previous section this enables them decide where, and to some extent when and how, they will declare their profits. It also lets them, to a quite substantial degree, determine what rate of tax they will pay, as examples such as Enron and Rupert Murdoch's empire have demonstrated.

This is a fiction that can no longer be tolerated. It is already creating great difficulties in ensuring fair corporate taxation across Europe, and it is a fiction that global business is manipulating to its advantage. This abuse can be tackled using a unitary basis for taxation. Under such a system all the profits of all the companies within a group are aggregated and them are reallocated to the countries in which the profits are earned using a formula, usually based upon a ratio of:

1. third party sales;
2. employees;
3. capital employed.

Such a formula almost invariably eliminates the allocation of profits to tax havens but does assist allocation of profits to developing countries.

Introduce general anti avoidance provisions into tax law

The world's lawyers and accountants have shown themselves to be adept at abusing all forms of detailed tax legislation wherever it has been introduced throughout the world, and to have little of no moral scruple about doing so.

This suggests that the time has come for tax legislation to be purposive rather than detailed. Of course detail is needed, but all language has its limits. To define an elephant is very hard, to identify it is very easy. Purposive legislation says what it is trying to do as well as saying how it is trying to do it. A person then has to show that to take advantage of it they have both complied with the rules of the law, and the spirit of the law as set out in the stated purpose of the legislation.

This is most easily enacted into law by the creation of what is called a "general anti avoidance principle", but it has then to extend to all new tax law to make sure it is effective. By introducing such laws it will be harder for the world's lawyers and accountants to abuse the best intent of those who wish to help developing countries collect the tax that is rightly due to them.

Automatic information exchange

Nothing will stop tax haven abuse more than the creation of automatic information exchange between all governments as to the income generated in their territories by person resident in the other government's territory.

This automatic exchange has to cover individuals, companies and trusts.

Sanctions must be applied against those who will not participate so that the cost they impose on others is recharged to them.

Is this possible?

The inevitable, final question must be "is all this possible?"

And the answer is yes. Everything suggested in this report could happen.

Developing countries could keep their profits, and the taxes due on them.

The abuse of the world by tax havens could be stopped.

The vast resources now wasted seeking to profit from tax abuse could be directed to more productive use.

Business could operate on a fair and level playing field when it comes to tax.

It requires just one thing to achieve these things. And that is political will.

Appendix 1

The tax havens of the world (some of whom would rather be called offshore financial centres)

The Caribbean and Americas
Anguilla
Antigua and Barbuda *
Aruba *
The Bahamas
Barbados
Belize
Bermuda
British Virgin Islands
Cayman Islands
Costa Rica
Dominica *
Grenada
Montserrat *
Netherland Antilles
New York
Panama
Saint Lucia *
St Kitts & Nevis *
Saint Vincent and the Grenadines *
Turks and Caicos Islands
Uruguay *
US Virgin Islands *

Africa
Liberia
Mauritius
Melilla *
The Seychelles *
São Tomé e Príncipe *
Somalia *
South Africa *

Europe
The Aland Islands *
Alderney *
Andorra
Belgium *
Campione d'Italia *
City of London
Cyprus
Gibraltar
Guernsey
Hungary *
Iceland *
Ireland (Dublin) *
Ingushetia *
Isle of Man
Jersey
Liechtenstein
Luxembourg
Madeira *
Malta *
Monaco
Netherlands
Sark
Switzerland
Trieste *
Turkish Republic of Northern Cyprus *

Middle East and Asia
Bahrain
Dubai *
Hong Kong
Labuan
Lebanon
Macau *
Singapore
Tel Aviv *
Taipei *

Indian and Pacific Oceans
The Cook Islands
The Maldives *
The Marianas
Marshall Islands
Nauru *
Niue *
Samoa *
Tonga *
Vanuatu

Source: Economist Intelligence Unit, OECD, John Christensen and Mark Hampton (UK academics working in this field)

Note: This list of 72 countries and territories excludes some territories which have some tax haven features but are not commonly used as such e.g. New Zealand. Those 34 territories marked with an asterisk have developed their activities in the last 25 years according to Christensen and Hampton, representing an almost doubling in the number of tax haven territories in that period.

Appendix 2

Transfer pricing

Market prices

Suppose:

- you have two companies, A Ltd and B Ltd;
- A Ltd makes a product called a widget that B Ltd wants;
- A Ltd and B Ltd are entirely independent. That means:
    - No one who owns a significant part of A Ltd owns a significant part of B Ltd;
    - Nor do any of their families own a part of B Ltd;
    - No one who is a director of A Ltd is a director of B Ltd.

Then in that case:

- A Ltd and B Ltd are considered to be independent companies;
- The price that A Ltd sells Widgets to B ltd at is expected to be the fair market price.

When this happens no tax authority is worried. It is presumed that both A Ltd and B Ltd tried to get the best price they could and the resulting profit or loss on the deal is the one that should be taxed.

Transfer prices

Now let's change some of the facts. Suppose any of the following happen:

- A Ltd owns B Ltd, or;
- one person, or a group of people acting together (such as members of a family) own both A Ltd and B Ltd; or
- a director of A Ltd also sits on the board of B Ltd.

Now there is no way you could say A Ltd and B Ltd are independent of each other. They clearly know each other well. They might be legally distinct but because they share so much in common they might act together to get the best overall profit for the pair of them. They are called "related parties".

This is not much of a problem if either:

1. both A Ltd and B Ltd are taxed in the same country, or;
2. they are taxed at the same rate.

In that case it is unlikely that they will be able to shift much of their tax burden by trading with each other.

The offshore dimension

This changes though if A Ltd is in a low tax country and B Ltd is in a high tax country. In that case:

- if A Ltd and B Ltd make equal profits A Ltd will pay less tax than B Ltd, so;
- the price at which Widgets are sold from A Ltd to B ltd might be increased so that A Ltd makes more profit than B Ltd.

The result is that the same overall profit is made, but because A Ltd makes more of it, and it only suffers a low tax rate, less tax is paid.

Adding some numbers

Some numbers make this easier to explain.

Suppose:

- a widget costs £700 to make;
- the fair market price for a Widget is £1,000 (this is what A Ltd would sell it for to anyone but B Ltd);
- B Limited can sell a Widget for £1,300;
- The tax rate in A Ltd's country is 5%;
- The tax rate in B Ltd's country is 35%

So:

- A Ltd should make £300 of profit and pay £15 in tax;
- B Ltd should make £300 in profit and pay £105 in tax;
- overall £600 of profit is made and £120 of tax is paid.

But now suppose A Ltd charges £1,200 for a Widget to B Ltd who can still sell it for £1,300. Then:

- A Ltd then makes £500 of profit and pays £25 in tax;
- B Ltd then makes £100 in profit and pays £35 in tax;
- overall £600 of profit is made and £60 of tax is paid.

As a result of the use of a "transfer price" rather than the use of a "market price" tax of £60 has not been paid in all, and the country in which B Ltd operates has lost out by £70, which is more than the overall saving.

Adding a twist to the tale

There's a further, common twist to this tale.

Suppose:

- A Ltd and B Ltd are in the same country, and should both be paying 35% tax;
- that the owners of A Ltd and B ltd form a new company, C Ltd. That is located in a tax haven which

charges no income tax at all on transactions not actually undertaken in its territory;

- then suppose A Ltd sells the Widget B Ltd wants to C Ltd first, for say £750;
- then suppose C Ltd sells that same Widget to B ltd for £1,250;
- B ltd then sells it to its customer for £1,300.

Now:

- A Ltd makes £50 of profit and pays £17.50 in tax;
- B Ltd makes £50 in profit and pays £17.50 in tax;
- C Ltd makes £500 in profit and pays no tax;
- overall £600 of profit is made and £35 of tax is paid.

As a result of the use of a "transfer price" rather than the use of a "market price" and by inserting a tax haven into the transaction flow tax of £175 has not been paid in the country in which companies A Ltd and B Ltd operate, although nothing at all actually happened in the country in which C Ltd operates.

How likely is this?

In Europe scams like the one involving C Ltd noted above are relatively unlikely now. Most tax authorities are now reasonable good at spotting these things.

As a result techniques used in Europe are much more subtle now and tend to involve the licensing of intellectual property from offshore companies, the true price of which is very hard to determine.

In Africa no one notices these things. It is incredibly likely that substantial amounts of profit are shifted out of Africa using transfer pricing techniques.