Summary Brief

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What is 'Offshore'? International Tax Evasion and Avoidance and How to Combat it

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This briefing aims to explain the 'offshore' system which enables both evasion and avoidance of tax, as well as of other types of laws and regulations, and discusses countermeasures. All illicit cross-border financial flows exploit the offshore system, so understanding how it works is the key to ensuring effective and coherent countermeasures, in relation to tax, money-laundering and corruption. It was written as a submission to the United Nations High Level Panel on Financial Accountability, Transparency & Integrity.

Offshore: an in-between space

National taxes on income, profits or gains usually apply to **income** defined by its source, or **persons** (individuals or legal entities) based on their country of residence or citizenship. Other kinds of rules, such as those on bribery and money-laundering, are usually also based on residence or citizenship, and/or the place where the activity takes place.

From early in the 20th century, when states started to rely on income taxes, wealthy individuals and transnational corporations (TNCs) began to find ways to evade or avoid them. The basic technique was to interpose an intermediary entity or conduit between the source of income and its beneficial owner. This could ensure that such income would not be taxed in either the source or residence country. The conduit could be a nominee account, or a legal person such as a company, or a trust. Such conduits are legal fictions, existing only on paper, electronically, or as brass plates on an office building. These assets can be used to generate income or gains from another country, to benefit persons resident in a third country. Generally, a chain of conduits is used, in a 'stepping-stone' structure, to avoid withholding taxes at source as well as residence tax (see Figure 1). It's also possible for a person to use an offshore structure to avoid tax in their own country of residence, known as 'round tripping'.

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Hence, 'offshore' is not a place but a system or legal structure, enabling people or companies based or living in high-tax countries to pay low tax. Different kinds of haven are generally used in combination, and almost any country can be a haven in some way and to some extent. That is why 'blacklists' of havens are of limited use. Much better tools are the Financial Secrecy Index, which ranks countries by factors reflecting their importance in the offshore system (FSI 2020), and the EU's Directive on reportable cross-border tax avoidance arrangements (EU 2018), which specifies the basic offshore structures based on their 'hallmarks'.

Although commonly thought of as small countries, portrayed as palm-fringed islands, countries of all sizes can act as havens, by providing offshore facilities. The central characteristic of offshore laws or regulations is that they benefit non-residents of the country. They can be deliberately designed to do so, or the benefit may simply result from limiting the scope of national rules to residents of the country. For example, in 1934 Switzerland's political and financial elites decided to reinforce its role as an offshore banking centre, which began early last century, by enacting a bank secrecy law criminalising any disclosure of information on clients (Farquet 2012, Guex 2000). Other jurisdictions have also passed strong secrecy laws to attract financial deposits from non-residents. Several European states, particularly the UK and the Netherlands, allowed or encouraged their colonies or dependencies to offer offshore facilities, which also benefited their own financial centres in London and Amsterdam.

Figure 1 Basic offshore 'stepping-stone' structure

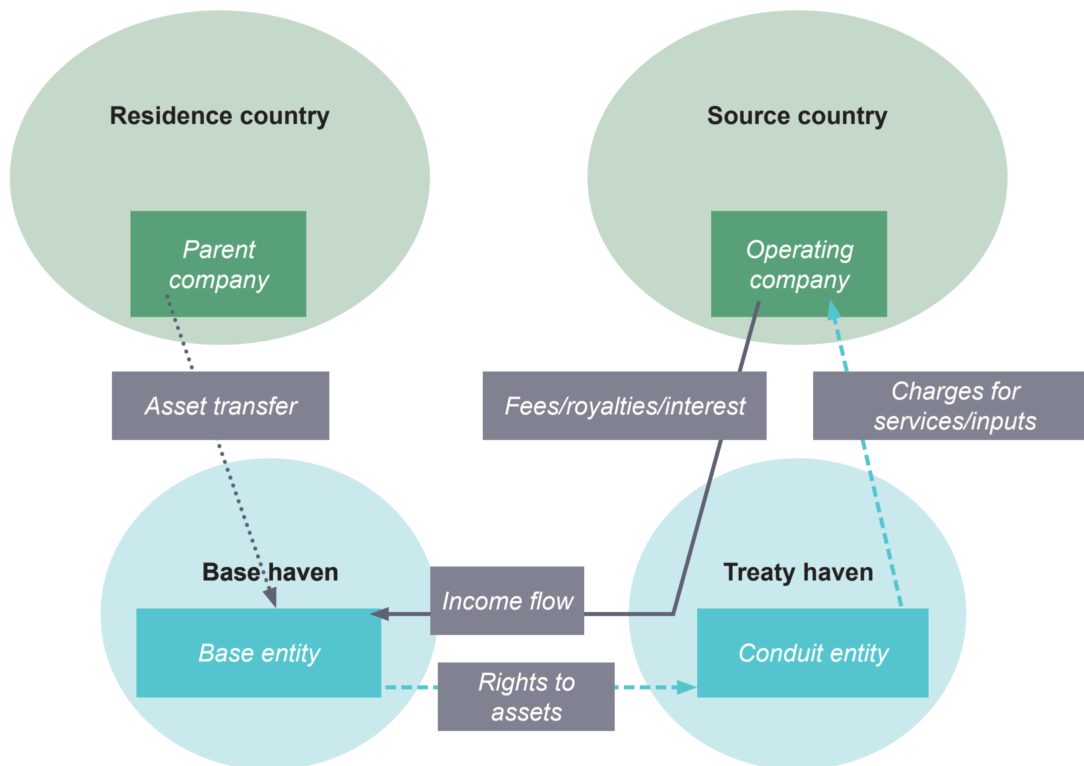

Image: Author's own.

Assets (capital, intellectual property rights etc.) are assigned at the direction of the Parent to a base entity resident in a zero-tax country, which lends or licenses them to the Operating Company via a conduit resident in a country with suitable tax treaties; the interest or royalties paid by the Operating Company reduce its tax on business profits, and are exempt from tax in the source country (due to the treaty); the Conduit also pays no or very little tax, passing the income through to the Base, where it is sheltered from Residence country tax, while being available to the ultimate owner.

Countries with large financial centres have also offered offshore facilities, by providing stronger protection of client confidentiality for non-residents. Confidentiality can usually be overridden by obligations to disclose information to tax and criminal enforcement authorities; but many countries refused to obtain such information to help other countries enforce their laws. Such obligations began to be accepted only relatively recently, for example the UK did so for tax matters only in 2000. Secrecy is also enabled by the lack in most countries of public registers of the owners or beneficiaries of legal entities such as companies, trusts or foundations. Hence, it is still possible to circumvent arrangements for exchange of information by owning assets through an entity in a jurisdiction with no register of beneficial ownership. Most US states have no corporate ownership register, and few countries require disclosure of the parties to trusts.

The grey zones: planning, avoidance and evasion

Using offshore arrangements may sometimes be proved illegal, under either civil or more rarely criminal law. For example, 'round tripping' is likely to be illegal. More often, such arrangements are designed to exploit legal 'grey areas' that result from the malleability of the abstract legal concepts, particularly residence and source. For example, the beneficiaries of an offshore trust can claim to have no income from abroad, even if the trustees invest its assets as they direct and use the income for their benefit. It is particularly difficult to prove that an arrangement is criminal, because this usually requires evidence of intent to break the law, or knowledge that the arrangement is contrary to law.

Wealthy persons or corporations can pay professionals to devise structures that can plausibly be argued to be within the law. The worse that can happen is that the arrangements may be investigated and if challenged may be found ineffective or unlawful. Since there is usually no penalty, especially if they are based on legal advice, entering into such arrangements entails little or no risk. At the worst, tax may eventually have to be paid, but meantime it is deferred. Hence, corporations have considered it legitimate to engage in avoidance, often described as tax 'planning'. Some even argue that they are required to do so in pursuit of profit.

Both international tax evasion and avoidance use the offshore system, deploying similar techniques that are linked and overlap. The frequent claim that tax avoidance is legal is mistaken. Tax avoidance arrangements are frequently **unlawful**, in that they do not succeed in avoiding tax. However, this greatly depends on the resources available for tax audit and investigation. The UN Financing for Sustainable Development report 2020 points out that data from the International Survey on Revenue Administration show that a high proportion of tax audits identify underreported taxes, although they rarely result in prosecutions for evasion (UN 2020, pp. 42-3). The data also show higher success rates for low-income countries, although obviously such countries lack the capacity for frequent audits, so much unlawful avoidance is undetected.

Hence, there is inevitably a 'dark figure' of tax that has been avoided or evaded without detection. When this occurs by using an offshore arrangement, it can be considered an illicit financial flow. It may result from ineffective enforcement, due to lack of resources or other reasons (including corruption), or from ineffective laws, sometimes in combination. Other kinds of illicit flows may also involve tax evasion or avoidance, so there is an overlap among these

categories, which should be taken into account in analysing and quantifying them.

A good example of the grey zones is the so-called Cum-Ex trading scheme which exploited double taxation relief and is estimated to have cost various European countries a total of some €60 billion, around half of that for Germany (Siegal 2020). This scheme was certified as legal by elite law firm Freshfields Bruckhaus, and has required enormous efforts by enforcement authorities to unmask, as well as amendments to legislation. Two bankers were finally convicted in late 2019, but they cooperated with prosecutors so received only suspended sentences (Storbeck 2020). Legal arguments can still be made that the facilitators committed no criminal offence, and even that the scheme was within the law.

The systematisation of offshore

The basis for offshore emerged during the period of high tax rates after the first world war. In addition to bank secrecy, some countries began to provide exemption from tax on foreign income for 'holding companies': Luxembourg enacted such legislation in 1929, and Swiss cantonal laws had the same effect, in partnership with Lichtenstein (Farquet 2017, 233-4). US lawyers enabled Panama to become a 'flag of convenience' for ships, to avoid labour legislation as well as tax, and later alcohol prohibition.

Following the second world war TNCs, especially from the US, further developed the offshore system to expand internationally despite restrictions on capital movements. For example, a US court decision considering a tax avoidance structure through a Swiss affiliate created by the US-based chemicals giant Du Pont in 1959, found an internal memo that stated:

> 'It would seem desirable to bill the tax haven subsidiary [in Switzerland] at less than an "arm's length" price, because: (1) the pricing might not be challenged by the revenue agent; (2) if the pricing is challenged, we might sustain such transfer prices; (3) if we cannot sustain the prices used, a transfer price will be negotiated which should not be more than an "arm's length" price and might well be less; thus we would be no worse off than we would have been had we billed at the higher price'.(Du Pont 1979, p.447).

This viewpoint became prevalent among TNCs and their tax advisers as early as the 1950s, leading to the systematisation of the use of offshore structures.

The use of offshore grew with the relaxation of currency and capital movement controls, and became generalised in the 1980s. International attempts to control the offshore system began in the 1990s, e.g. through the Financial Action Task Force (FATF, set up in 1989) and the Egmont Group (set up in 1995) to deal with money-laundering, and by the Basle Committee on Banking Supervision for financial prudence standards. However, the tax aspects were taken less seriously, and the G8/OECD project on 'harmful tax practices' begun in 1996 resulted only in some improvements in exchange of tax information on demand. There was little coordination between tax authorities and those responsible for financial supervision. The FATF did not extend its reporting standards to tax until 2012, and then only for 'tax crimes'. The improvements in financial supervision enabled havens to proclaim their high standards and so strengthen their attractiveness, while continuing to resist cooperation in tax enforcement.

At the same time, TNCs further refined their tax avoidance structures, taking advantage of

a fundamental flaw in international tax rules. When these laws were devised in the 1920s it was understood that TNCs are unitary firms operating under central direction and control, so tax authorities were given the power to adjust the accounts of their local subsidiaries or branches in each country to ensure a fair allocation of the global profit. However, it was agreed to focus on the accounts of each national affiliate, adjusted to ensure that they showed a level of profit in line with similar independent companies. In practice this gave a green light for TNCs to set up offshore entities, which expanded from the 1950s. This was further encouraged by the Guidelines on Transfer Pricing issued by the OECD in 1995. These reinforced the 'arm's length' principle, requiring the attribution of profits to be based on analysis of the functions performed by each affiliate and on the pricing of transactions between them. TNC tax advisers built on this to create even more complex corporate structures, fragmenting activities and locating affiliates fulfilling high-value functions in low-tax countries (Picciotto 2018, pp. 40-42). This was further facilitated by the digitalisation of the economy, which made offshoring easier.

Combatting the offshore system

More determined efforts have been made to combat the offshore system in the past decade, due to the political pressures created by the fiscal crises following the great financial crash of 2007-9 (Picciotto 2020). These have aimed at both tax evasion by rich people and avoidance by TNCs. While great strides have been made, more still needs to be done to make these measures effective, especially for developing countries. It is also important to improve the coherence between tax measures and those aimed at money-laundering and corruption.

Comprehensive automatic exchange of tax information

The OECD's Common Reporting Standard (CRS), established in 2014, provides a basis for automatic exchange of financial account information for tax purposes between all countries, supervised by the Global Forum, based at the OECD. This is a major step forward, but significant improvement is needed.

In 2019, 95 countries participated in exchanges, but this still does not include most developing countries. A major gap is that the USA is not participating, so its own system under the Foreign Account Tax Compliance Act (FATCA) is not subject to peer review. The Global Forum's peer reviews of the exchange of information on request have found the US only 'partially compliant' on the availability of ownership and identity information. Also, the US bilateral agreements under the FATCA are asymmetrical, the information supplied by the US to its partners does not comply with the CRS, and is less than it receives (Knobel 2016, pp.13-14). The US has 113 agreements in force under the FATCA, but only 98 that provide for even this limited degree of reciprocity.

This still falls well short of a global system: only four African countries have participated in the OECD system by the end of 2019 (Ghana, Mauritius, Seychelles and South Africa), and six have agreements with the US (Algeria, Angola, Cabo Verde, Mauritius, Seychelles and South Africa).

Recommendations: (i) To improve coherence and alignment the US should either join the CRS system, or ensure full reciprocity and participate in the peer reviews by the Global Forum; (ii) a major effort is needed to build the capacity of developing countries to participate in the CRS, and particularly to enable them to make good use of information they would receive through it.

Beneficial ownership

The very existence of automatic exchange of information is an important deterrent, but its sustainability and effectiveness depend on the quality of the information. The key to this is transparency of legal persons and arrangements, to ensure that information is provided on the real individual who is the beneficial owner (BO) of income. The CRS covers only accounts with financial institutions, and the quality of the information exchanged relies on accurate identification of beneficiaries.

The Global Forum has adopted the FATF Guidance on Beneficial Ownership (FATF 2014) which, together with its Best Practices guidance (FATF 2019) recommends a 3-pronged approach to identification of BOs. One of these utilises ownership registers (for companies), the others depend on obligations for financial institutions, companies or professional service providers to hold and supply the data when required. Although they recommend combined use of all three sources, neither the FATF nor the CRS require the establishment of ownership registries, nor do the High-Level Principles on BO Transparency adopted by the G20 leaders in 2014. Hence, in most countries identification of beneficial owners largely relies on service providers or financial institutions, many of which have been found delinquent in the past. Also, determined evaders can still hide behind layers of entities and nominees.

The international standards clearly show that a key element in an effective system is the establishment of public registries. Due to political pressures, in 2018 the EU amended its money-laundering Directive to require public registers for companies, trusts and other legal entities, and in May 2020 adopted an Action Plan for a comprehensive policy, including EU-level supervision. Some other countries have adopted such policies, such as the Ukraine.

Recommendations: (i) monitoring of the CRS should include evaluation of the quality of compliance by financial intermediaries with the requirement to identify beneficial owners; (ii) both the FATF and the CRS should require the establishment of public registries of beneficial ownership of legal entities, and of other assets, available for searching online; (iii) the FATF and CRS should establish a limit on the 'layering' of legal entities, by obliging participating jurisdictions to require that participation in a legal entity by other than a natural person is permissible only if the ultimate BOs in that entity can be ascertained; and (iv) there should be further strengthening of cooperation between authorities responsible for tax and money-laundering, both at international level (OECD and FATF) and national level (e.g. through improving the sharing of data between revenue authorities and financial information units).

Ending TNCs' use of offshore structures

The Tax Annex to the G20 world leaders Declaration in 2013 mandated the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) to reform international tax rules to ensure that TNCs could be taxed 'where economic activities occur and value is created'. This clearly requires ending TNCs' use of offshore arrangements. Unfortunately, the first outcomes of the BEPS project in 2015 only patched up existing rules. In particular, the arm's length principle was retained, with extensive amendments to the Transfer Pricing Guidelines, which only made them even more complex.

The main advance was the establishment of a system of Country-by-Country reports (CbCR) by TNCs, which for the first time will provide

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an overview of all the TNC’s affiliates in every country, and the assets, employees, income and tax paid and due in each country. However, the CbCRs are delivered to the tax authority of the TNC’s home country, and access is available only to tax authorities of other countries participating in a system run by the OECD, which polices compliance with its rules. These include strict requirements of confidentiality, as well as insistence that countries apply the arm’s length principle and the OECD approach to transfer pricing. Consequently, very few developing countries are able to receive CbCRs (in Africa only Mauritius, Seychelles and South Africa). The CbCR scheme is under review this year by the G20, but the consultation document issued by the OECD does not propose any improvement in transparency of the reports. Nevertheless, the many submissions by civil society organisations to this consultation, as well as some by small business and others, strongly urged that CbCRs should be public. CbCRs contain high-level information, so could not reasonably be considered commercially confidential. The Global Reporting Initiative has issued a standard for corporate public disclosure on tax which includes a template for CbCR (GRI 2019), which is close to that of the OECD. This was developed in consultation with TNCs and stakeholders, and has support from many in the business and investment communities, but it is voluntary.

The work on the BEPS project on international tax implications of digitalisation of the economy reached the important conclusions that (i) the whole economy has been affected, not just a particular sector, and (ii) it has exacerbated the problems of existing tax rules. The continuing work is focusing on the central principles of taxable nexus and allocation of profits of TNCs. The latest proposals have moved towards more simplified methods of allocation, starting from the TNC’s global profits, which is a significant step forward. However, they still envisage a continuing important role for existing transfer pricing methods, which provide a perverse incentive for TNCs to devise complex offshore structures.

Effective taxation of TNCs should be based on treating them in accordance with the economic reality that they are unitary firms under centralised control. Three methods of unitary taxation were evaluated by the Independent Commission for the Reform of International Corporate Taxation (ICRICT 2019), which concluded that the fairest and most effective method would be formulary apportionment. The G24 group of developing countries has put forward proposals for apportionment based on a balance of factors of production (employees, users, working capital) and consumption (sales). Due to the Covid crisis efforts to achieve an agreed solution this year are likely to focus on the specific problem of highly digitalised firms, but it is hoped that a wider solution could be found in the near future.

Recommendations: (i) the G20 should this year require publication of country-by-country reports; (ii) the BEPS project should develop principles for formulary apportionment of TNC profits along the lines of the G24 proposals.

Further reading

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Credits

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