

Research report

Issue:

Forum:

Assembled by:

**Creating a fair tax system for all
GA2**

Huib van Erp and Jordy Ossendrijver



Introduction:

Taxation is fundamental to the functioning of any government, for all governments require income to perform their governmental functions, and taxation provides income. In many countries tax systems have become complex, to fairly harvest enough taxes to sustain and develop their services to the public. Consumer income, purchases of everyday goods and financial assets are all being taxed. Since taxes are conventionally percentages of the value of that which is taxed, wealthy individuals pay more taxes than less wealthy individuals, absolutely spoken. Thus the wealthy form a large potential source of tax income. However, many wealthy individuals use tax havens to evade having to pay taxes over large financial transactions and assets. Through these tax havens, which will be addressed in more detail later on, corporations and individuals alike manage to transfer large sums of money from jurisdictions with relatively high tax rates to so called 'secrecy jurisdictions', jurisdictions with low tax rates and strict privacy laws in favour of corporations. From 2012 research by the Tax Justice Network¹ an estimate of 21 trillion dollars (21.000.000.000.000, for visualization) worth of assets is left untaxed through tax havens. This number might sound astronomical as it is, yet it falls short of the harsh reality. In early 2016 an unknown man who went by the name of John Doe contacted the Süddeutsche Zeitung, a Munich-based regional newspaper, asking them whether they were interested in valuable information.² What followed was 2.6 terabytes worth of data, over 11.5 million documents (to compare, the Wikileaks scandal in 2010 contained only 1,7 GB of data.) The documents came from the database of a Panamanian company, Mossack Fonseca.³ This company helps its clients in setting up offshore companies and letterbox companies, necessities for a successful tax evasion. The leaks revealed the names of many of their clients, including many politicians, close relatives and friends to politicians and political leaders and even professional athletes like Lionel Messi. This leak made clear how widespread and immense tax evasion has become and how much tax revenue countries are missing due to these practices. Tax revenue that could be used for humanitarian aid, development aid, development of medicine and general economic improvement. The UN thus urges this council to consider measures in order to combat this phenomenon, with the aim of creating a transparent global market.

Tax havens:

A tax haven is used to evade taxes. Wealthy corporations and individuals set up letterbox companies (offshore companies) in tax havens. These letterbox companies do not operate in any way, they only own other companies. Through this legal loophole, actual companies (e.g. Apple, Amazon) can transfer their profits to the letterbox company in the tax haven, where the tax rates are substantially lower than in the home country. This may sound complex, so let's break it down step by step:

STEP 1:

You are the owner of a large electronics company, based in Paris, France. Your phones are produced in Vietnam in your own factory (a second company besides your Paris based company) and are sold on the French market. They are produced for \$100 and sold for \$400. You make \$300 per phone, but you have to pay taxes over these profits in

¹ International organization combatting unfair taxation practices, <http://www.taxjustice.net>.

² <http://panamapapers.sueddeutsche.de/articles/56febf0a1bb8d3c3495adf4/>.

³ <http://www.mossfon.com>.

France. Your company has developed an innovative phone, and sales are booming. Your company is making large money now, however, you do not like the 33,33% corporate tax rate in France.⁴ This tax rate might not sound too bad (income tax rates are around 50%), but when you are making millions a year, you are also losing millions a year to taxation that way. Time to find a tax haven.

STEP 2:

Finding a tax haven is not hard. The world counts around 70 places that qualify as tax havens. We will keep it simple and pick one of the most popular tax havens in the world: the Cayman Islands. These islands count only 60.000 inhabitants, but now form the world's sixth largest banking centre.⁵ Laws that allow nominees for ownership of corporations⁶ and a staggering corporate tax rate of 0% make the Cayman Islands a great tax haven.⁷ Time to set up your first offshore company.

STEP 3:

A local company, which wishes to remain anonymous, has helped you set up your offshore company and a bank account with a local bank. Your company has an office in the capital of George Town, almost ready to make money.

STEP 4:

Only one more step and your company is ready to avoid those annoying French taxes. To ensure your anonymity and safety, you need a nominee to be the 'owner' of your offshore company. The janitor from your new 'office building' in George Town is willing to be the owner, for a fee of \$100 per month. You can trust him, he has done this before.

STEP 5: MAKE IT RAIN!

You are now completely ready to evade some taxes, so let's get to it. You still produce your phones in Vietnam, \$100 per phone, and you still sell them in France for \$400. But you don't pay the high French taxes over your \$300 profit anymore, you now pay the comfortable Cayman tax rate of 0%! It's a very easy trick. After your company in Vietnam had produced the phones, your company in the Cayman Islands bought the phones for \$100 each. The costs and benefits in Vietnam are equal, which means you make no profit and thus you pay no taxes. Your offshore company now sells the phones to your Parisian company, for the projected sales price: \$400 each. This means that the Parisian company does not make any profit either: it buys and sells the phones for \$400 each. No profit means nothing to tax for the French government. Your profit of \$300 per phone is no longer made by your Parisian company, but by your offshore company. Fortunately, the Cayman Islands have a 0% tax rate, so you end up not paying any taxes. You now make \$300 per phone, whereas you made only \$200 profit per phone after the French taxation. This might seem complicated, yet the most beautiful part, it is all orchestrated from your office in France, and the phones never even made it to the Cayman Islands. Effectively,

⁴ <http://www.tradingeconomics.com/france/corporate-tax-rate>.

⁵ <http://www.financialsecrecyindex.com/PDF/CaymanIslands.pdf>.

⁶ A common practice in tax havens, on paper a nominee owns the offshore company, which allows the real owner of the company to remain anonymous. Mossack Fonseca has an extensive program that provides nominees for their clients.

⁷ <http://www.tradingeconomics.com/cayman-islands/corporate-tax-rate>.

nothing has changed except for the destination of your profits. Congratulations, you successfully evaded taxes.

What defines a tax haven:

For a country to be a tax haven is not hard. The first requirement is stability; a stable government and economy are of the essence to safely stash large sums of money. If the bank that supervises your assets gets in trouble due to economic or political instability, you might lose some of it. Also, economies that use a strong coin, like the US dollar, are very convenient. A second requirement is secrecy. When setting up an offshore company it is important to make sure few people know of its existence and, more importantly, its creditor. To ensure this some simple legislation needs to be passed. This legislation usually allows for nominee-ship⁸ and prohibits the exchange of tax returns and other information regarding taxation with foreign authorities. A last important requirement is lack of physical presence. A proper tax haven does not require the 'residents' of the country to physically be present in the country. As long as they are present on paper.

Where to find tax havens:

The Tax Justice Network has produced a list in which tax havens worldwide are ranked, based on their secrecy and their share in global finance export services (e.g. Mossack Fonseca).⁹ The top 10 of this list comprise some familiar names, but countries like Germany and Luxembourg also appear in the top 10. However, the most popular places to set up offshore companies are mainly tropical countries, many of them being UK Overseas Territories or Crown Dependancies (meaning the UK is ultimately responsible for them, even though they have gathered self governance competences). These islands, often in the Caribbean or the Pacific, used to be colonies to European governments, making their money through trade with the mother nation. When they were given more independence, political and economic, the former colonies were often left with the question of how to sustain a profitable economy. There were two easy options: tourism and tax havens. Many combine the both of them, like the Cayman Islands, Bermuda, the Bahamas, and the British Virgin Islands. The list of tax havens is very extensive, including the United States of America (the states of Nevada and Delaware mainly), Japan, the United Kingdom (London and the OT's and CD's), the Netherlands, Singapore, Hong Kong, and many more smaller countries, like Macau, the Turks and Caicos Islands, Jersey, Guernsey, the Isle of Man and Mauritius.

Users of tax havens:

Finding out who uses tax havens is a difficult task, yet the 2016 Panama Papers leak has shed a painful light on the situation. The International Consortium of Investigative Journalism is examining the data and has found many important people to be linked to tax evasion in tax havens.¹⁰ Clients of Mossack Fonseca included political leaders, like the Prime Minister of Iceland, the King of Saudi Arabia and the presidents of the United Arab

⁸ See footnote 6.

⁹ The Financial Secrecy Index, published in 2015, <http://www.financialsecrecyindex.com/introduction/fsi-2015-results>.

¹⁰ The Consortium is still investigating the matter. They have created a very informative website, we urge all delegates to visit this website so that they may get an impression of the magnitude of this issue. <https://panamapapers.icij.org>.

Emirates, Argentina and the Ukraine. Furthermore, close relatives and friends to the leaders of China, Russia, Morocco, Azerbaijan, Syria, the United Kingdom, Pakistan, South Africa, Malaysia and Mexico are clients of Mossack Fonseca. Many politicians and public figures from countries all around the globe have also been found to have large assets in tax havens, including UK MP's, many (former) European ministers, the Saudi Crown Prince and even the son of the former UN Secretary General Kofi Annan. Yet the list goes on and on. An estimate of 350 multinationals use tax havens to avoid taxes. Millionaires and athletes, criminals and terrorist organizations, all participate in tax evasion.

Consequences of tax havens:

The consequences of tax evasion at this scale are enormous. A quote from an investigation by Oxfam International illustrates the size of the issue: 'Tax dodging by multinational corporations costs poor countries at least \$100 billion every year. This is enough money to provide an education for the 124 million children who are not in school and fund healthcare interventions that could prevent the deaths of at least six million children every year.'¹¹ The ones that are impacted most by tax evasion are regular people, mainly in developing countries. The loss in tax revenue generated through tax havens is extraordinarily large, tax revenue that could have been used to boost the economy, to provide public services, to develop health care and education or to counter climate change. The large loss in tax revenue is not the only problem, tax evasion through tax havens also creates a dangerous cash flow away from fragile economies. Instead of being in circulation large sums of money are now frozen in tax havens.¹² A second problem arising from tax havens is the 'race to the bottom.' Countries that are not tax havens are competing with tax havens in order still attract business and investments. This means corporate tax rates all around the world are lowering. OECD¹³ countries had an average corporate income tax rate of 32% in 2000, the average rate in 2015 was only 25%. Several countries are working on lowering their tax rates even further. The United Kingdom is planning on lowering from 20% to 17%, newly inaugurated president of the United States Donald J. Trump promised to lower from 35% to 15% and Australia to go

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<https://www.oxfam.org/en/pressroom/pressreleases/2016-12-12/worlds-worst-corporate-tax-havens-exposed-oxfam-report-reveals>.

¹² This problem might need some addressing on an economic level. An economy is like an ever moving system, people make money and when they do so, they spend money. These spendings then allow other people to make money, which will get them to spend etc. This used to be mainly confined to a national or regional scale, yet in the 20th and 21st century the scale has shifted to a global scale. So, money circulates around and around and in the process it allows people to gain wealth and material and it allows the economy to grow. Yet as soon as a small group of people start accumulating large parts of the total amount of money in circulation, as is happening through tax havens and modern consumerism, a substantive part of that money freezes. When one makes way more than they spend, as is the case with many modern day millionaires, the excess gains are put in real estate or bank accounts, and are left largely untouched, thereby taking the money out of the economy. Large sums of money are now stashed in tax havens, where they hardly circulate at all. Without circulation, the growth of the economy stops.

¹³ Organisation for Economic Co-operation and Development, <http://www.oecd.org>.

from 25% to 20% over the next years.¹⁴ This means less tax income and thus less development aid, public services and possibly an eventual increase in other forms of taxation. This race to the bottom might seem fruitful on short term, but it could have dangerous consequences in the future. The last problem is somewhat more of a more speculative nature. Tax havens allow, through their secrecy laws, anybody to stash large amounts of money in anonymous bank accounts. This allows criminals active in the organized crime world to easily hide their money. Also terrorist organizations are keen to use the services of tax havens. Not only do these organizations and individuals get the opportunity to hide their money, they also get the opportunity to spend it without anybody being able to trace the transactions back to the real owner of the money. Investigations into the Panama Papers have shown that offshore assets have secretly been used to support arms dealing, drug trafficking and illegal underage prostitution and human trafficking. It does not stop here. In the light of the ongoing conflict and the many civilian casualties in Syria several important governments banned the sale of arms and fuel to the Syrian presidential army in 2014. The Panama Papers revealed that many company still sold to the Syrian army after this ban, making use of the secretive world of offshore companies.

Previous efforts to stop tax havens:

Several NGO's¹⁵ are trying to combat tax havens, including Oxfam International, the OECD and the Tax Justice Network. However, this fight is a hard one. They get little support from governments and corporations for obvious reasons. Tax Information Exchange Treaties might be a possible solution to the problem, for they provide more transparency between governments. However, it is especially hard to have the right governments sign these treaties. Also, the European Union is working on Tax Haven Blacklist as well as an Anti-Tax Avoidance Directive, yet these plans are still in development. Lastly, the OECD and the Council of Europe have developed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.¹⁶ This convention is aimed at the exchange of tax information and the recovery of tax losses. Even though it has 106 signatories, it is questionable whether it will be any successful, for it heavily relies on the compliance of the signatory states. No higher authority for the regulation of taxes and tax information exchange has been instituted as of yet.

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<http://theconversation.com/race-to-the-bottom-on-company-tax-cuts-wont-stop-tax-avoidance-69209>.

¹⁵ Non Governmental Organisations

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http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/the-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters_9789264115606-en#.WlojjHeZNE4.

