Tax havens, secrecy jurisdictions and the breakdown of corporation tax

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United Kingdom: a case history

In March 2011, the Chancellor of the Exchequer, the British cabinet minister who is responsible for all economic and financial matters, announced in his budget statement three major changes to UK corporation tax.

The first was that the rate for large companies in the UK was set to fall to 23%. The second was that the UK would move to a corporate tax system where only the profits of companies arising in the UK would be subject to UK corporation tax; this representing a compete reversal of the situation that existed prior to 2009 when UK companies were (albeit convolutedly) taxable on their worldwide income. And thirdly he announced that if in the future a UK company runs its internal banking arrangements through a tax haven subsidiary then that company will benefit from a special UK tax rate of just 5.75 per cent of the resulting profits.

Such a thing has never happened before. First, the Chancellor has swept aside a tradition dating from just after capital account liberalisation took place in the UK[2] in 1979. In 1984 the UK introduced what are known as Controlled Foreign Company (CFC) rules[3] into its tax code. These allowed it to deem subsidiaries of UK parent companies located in tax havens to be UK tax resident, and so UK taxable. The whole purpose was to prevent a company relocating its profits, and most especially those arising on financing charges, to tax havens. And yet the new UK law is designed to encourage precisely this tax haven activity by UK owned parent companies by allowing it to be undertaken and to be deemed to be in the UK but to then be taxed at a new tax rate that is exceptionally low: the lowest indeed offered on corporate profits anywhere within the European Union or Organisation for Economic Cooperation and Development[4]. Extraordinarily, this activity has always been considered aggressive tax avoidance to date.

As a result in one announcement Osborne summarised a change in attitude in UK taxation that will delight corporate tax avoiders everywhere: what he was saying was that the UK will now condone tax haven activity undertaken by UK parent companies in locations such as the Cayman Islands, Jersey and the Isle of Man. By 2016 it is expected that more than one

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[1] Richard Murphy is a co-author of 'Tax Havens: How Globalization Really Works', Cornell University Press, 2009.

[2] See, for example, Quinn, D. and Voth, H., 2007, Free Flows, Limited Diversification: Explaining the Fall and Rise of Stock Market Correlations, 1890-2001 http://www.cepr.org/meets/wkcn/1/1688/papers/Voth.pdf accessed 25-5-11

[3] http://www.ukbudget.com/UKBudget2010/business/UKBudget2010-business-Controlled-foreign-companies-reform.cfm accessed 25-5-11.

[4] Based on a review of rates noted in KPMG's annual survey of corporate tax rates at http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/Corp-and-Indirect-Tax-Oct12-2010.pdf

sixth of UK corporation tax will come from the offshore activities of UK companies[5]. It is an astonishing change in attitude to tax haven activity.

Definitions of 'tax haven'

It's all the more astonishing because no one has yet offered a definition of 'tax haven' on which everyone can agree[6]. The IMF, the OECD and the other main agencies tend to adopt the language they think acceptable to their own constituency. The term 'tax haven' is too obviously value laden, as the French translation (*paradis fiscal*) makes clear. 'Offshore', too, conjures images of island paradises, and besides, some of the locations involved – Liechtenstein, for example – are landlocked. 'International financial centre', a creation of the financial services industry, seems designed solely to give an air of respectability.

The reality is that there are at least four primary uses for 'tax haven' locations[7]. First, they are used by those wishing to avoid or evade their obligation to pay tax. Tax avoidance is legal, but outside the spirit of taxation law, while tax evasion is always an illegal activity involving the non-disclosure of a source of income to a taxation authority that has a legal right to know about it.

Second, they are used to hide criminal activities from view. That criminal activity might be tax evasion itself, but might also be money-laundering or crimes generating cash that needs to be laundered – theft, fraud, corruption, insider dealing, piracy, financing of terrorism, drug trafficking, human trafficking, counterfeiting, bribery and extortion.

Third, they are used by those who want their activities to be anonymous, even if they are entirely legitimate. Some people wish to hide their wealth from their spouses, for example; others might want to conduct trade which, though legitimate, might risk their reputation.

Fourth, they are used by those seeking somewhere cheaper to do business; in these locations they can usually avoid the costly obligation to comply with regulations that would apply if the transaction in question were undertaken.

Secrecy jurisdictions

The need for anonymity is common to all these cases. Transactions in these locations take place in what one might call the 'secrecy world'[8]. Secrecy is a property right like any other. To create and protect it requires the rule of law. Governments that choose to create laws permitting the existence of the secrecy world must have status as international

[5] Table c.3 of HM Treasury March 2011 Budget Statement http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf , accessed 25-5-11.

[6] Palan, R., Murphy, R., and Chavagneuc, C. 2010 'Tax Havens: How globalisation really works', Cornell University Press, pages 18 – 30.

[7] Murphy, R. 2008 'Creating Turmoil', Tax Justice Network, p34 http://www.taxresearch.org.uk/Documents/CreatingTurmoil.pdf , accessed 25-5-11.

[8] Much of the liguistic analysis that follows is based on Murphy, R, 2009, Rethinking the language of 'offshore', Tax Justice Network http://www.secrecyjurisdictions.com/PDF/SecrecyWorld.pdf

jurisdictions (although not necessarily as countries, as the British Crown Dependencies demonstrate). Since no jurisdiction willingly undermines its own laws, the secrecy such a jurisdiction provides can be used only by people residing outside its own domain. The regulations created by these 'secrecy jurisdictions' are designed to undermine the legislation or regulations of another jurisdiction. To facilitate matters, secrecy jurisdictions also create a legally backed veil of secrecy to ensure that those making use of its regulations cannot be identified as doing so.

Secrecy jurisdictions undertake this activity to raise revenue by collecting fees from registering companies. They may also charge fees for the regulation of the financial services industry located in their domain. And they may well collect significant amounts of tax on the personal earnings of anyone working in that industry, through income tax or sales taxes. In some locations, such as Jersey, taxes on the profits of banks comprise a significant part of the state's revenue and the financial services industry accounts for half of GDP[9].

All this is possible because secrecy jurisdictions create the structures that the financial services industry sells access to from these locations[10]. Typical among these structures are tax haven companies. These are extremely secretive: no information about them is made available on any public register, and very often the local tax authorities know nothing about them either. Yet even that level of secrecy tends to be insufficient for those engaged in offshore activities. The tax haven companies are almost invariably owned by trusts, which trusts are also registered offshore, and are run by the local financial services industry through specialist companies. The trusts are completely anonymous: there is no record of them on any public register; they are not taxed locally and so local tax authorities know nothing of them. The person creating them is not identified in the trust documentation, and the documentation never specifies who the beneficiaries are. An offshore company owned by an offshore trust creates an almost impermeable barrier to inquiry, equivalent to the banking secrecy offered by places like Switzerland, not least to law enforcement agencies and tax authorities around the world – hence the reputation offshore has for assisting crime.

The bankers, lawyers and accountants who operate from secrecy jurisdictions, who I collectively term the 'secrecy providers', provide 'secrecy services' to their clients. Collectively these secrecy providers comprise what have been called 'offshore finance centres' or 'international finance centres'. Both terms suggest a focus on finance, but that is misleading. Secrecy is the primary product sold by secrecy providers from secrecy jurisdictions. Without it the other services sold would not be viable.

It is important to realise that the customers for secrecy services will never be found in the secrecy jurisdiction in which their secrecy provider is located. They are always located 'elsewhere' – that is, somewhere outside the secrecy jurisdiction's domain. 'Elsewhere' is, in many ways, a more appropriate term than 'offshore'. The concept of 'elsewhere' allows secrecy jurisdictions, secrecy providers and their customers to maintain the claim that they are conducting legitimate, well-regulated business activity, because the substance of the transactions arranged by secrecy providers always takes place 'elsewhere' as far as the secrecy jurisdiction is concerned. Regulatory compliance within the secrecy jurisdiction is, as a result, easy to engineer, because nothing happens there. But, owing to the secrecy that the

[9] See Meinzer, M. 2009, Share of Financial Services in GDP, Tax Justice Network http://www.secrecyjurisdictions.com/PDF/FS_to_GDP.pdf

[10] Palan, Murphy & Chavagneux, Chapter 3.

secrecy jurisdiction provides, transactions undertaken 'elsewhere' will also fall outside regulation in the place where their substance really occurs: that, of course, is the intention.

So, for example, secrecy jurisdictions argue that because the transactions secrecy providers arrange take place 'elsewhere', they are not taxable within the secrecy jurisdiction because those places choose not to tax transactions outside their domain. They then insist that declaring these transactions where their substance really arises – wherever 'elsewhere' might be – is the responsibility of their clients. That way the secrecy providers are able to argue that they are fully tax compliant.

We might think of this domain, in which the real transactions arranged by real secrecy providers take place, as the 'secrecy space'. It is always 'elsewhere', and in that sense does not exist, but the willingness of secrecy providers, their clients, governments and authorities to behave as if it did creates the libertarian dream of an ungoverned domain for the making of unregulated profit. What this means though is that multinational corporations do not really have offshore operations: they simply record some transactions in the secrecy space. George Osborne's corporation taxation reforms give the clearest possible indication that the UK Treasury has accepted the legitimacy of the secrecy space.

Those changes will inevitably result in a loss of tax revenue to the UK. Serious as that is, there will be other consequences too. The UK is actively encouraging companies to conduct transactions in the secrecy world, but who will regulate the resulting trade? Just as important, what are the implications for governance when a government and major corporations condone the use of a space that exists only as a legal fabrication? How can we even estimate, still less do anything about the risks associated with the secrecy space but which can, and so emphatically did in 2008, have domestic and global implications?

Conclusion

Unaccountably, professional economists have almost entirely ignored the issue of tax havens. The few tax academics who have examined them argue that tax havens are beneficial[11]. And yet it is obvious that tax havens, by denying access to information, are an aberration in neoclassical economic theory bound to result in the misallocation of resources in a market system. To some in the market – individuals as well as corporations – tax havens are, needless to say, of enormous benefit. Those who have access to them will, given the prices charged, be those with access to significant wealth. They reduce their effective tax rates by cloaking their tax avoidance and tax evasions in secrecy; their capital increases exponentially quicker than others' as a result; this fact is hidden from view and, as a result, does not attract comment. No wonder tax havens continue to survive. But the question that needs to be asked is, who is paying the price of that survival, and should they be doing so?

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http://rwer.wordpress.com/2011/09/06/rwer-issue-57-richard-murphy

[11] A perfect example comes from Prof James R Hines of University of Michigan, a regular apologist for tax haven activity, in an article entitled 'Treasure Islands', 2010, Journal of Economic Perspectives—Volume 24, Number 4—Fall 2010—Pages 103–126 http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.24.4.103