

The problem of Taxleaks:

Analysis of effects of corporate ownership and tax anonymity¹

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1. Introduction: "Taxleaks" scandals

"Just as any revolution eats its children, unchecked market fundamentalism can devour the social capital essential for the long-term dynamism of capitalism itself"³. Offshoreleaks, Luxleaks, Swissleaks, Paradise Papers... tax avoidance, corruption, bribes, money-laundering. In yesterday's world, it was fashionable to hide ultimate beneficial owners and reduce the level of corporate taxation to levels of four, one or even zero percent. Due to this fashion, today, there

¹ This contribution is a follow-up to the project of Centre of Economic Studies of University of Economics and Management.

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³ Mark Carney, "Bank of England governor: capitalism doomed if ethics vanish", the Guardian, 28 May 2014.

is almost USD 2 trillion of profits hidden in tax havens out of reach of tax authorities of states where these profits were generated.

The possibility to create global opaque corporate structures is a direct consequence of the liberalisation of capital movements across the globe in recent decades. Today, any company can create a subsidiary in almost any country in the world. If, on the one hand, companies may extend their corporate ownership and tax structures to almost any country on the globe, on the other hand, authorities cannot follow those structures in all countries since companies may establish subsidiaries in countries which do not share information on corporate ownership. This information asymmetry leads to a number of negative effects, such as:

- (a) corporate tax avoidance;
- (b) discrimination of SMEs;
- (c) ineffective law enforcement, financing of economic criminality by public funds, corruption and activities of third states subject to EU sanctions;
- (d) state capture causing inflated public spending.

The economic data which give a flavour of sums we are talking about are astounding. According to OECD data estimates the amounts held offshore reach USD 1.9 trillion⁴. Zucman points out that "the use of tax havens has steadily increased in the recent decades and continues to rise with no particular sign of slowing down⁵" on both coasts of the Atlantic⁶. In the area of money-laundering: the European Commission estimates "the amount available for money laundering

⁴ OECD Economic Surveys, United States, June 2014.

⁵ "The available evidence suggests that artificial profit-shifting has a much larger effect in reducing corporate income tax payments, [...]. As tax havens rose as a share of foreign profits (to 55 percent today) and foreign profits rose as a share of total U.S. corporate profits (to about one-third), the share of tax havens in total U.S. corporate profits reached 18 percent (that is, 55 percent of one-third) in 2013. That is a tenfold increase since the 1980s [...]. In sum, out of the 10 points decline in the effective tax rate between 1998 and 2013, 2 to 4 points can be attributed to changes in the U.S. tax base and the Great Recession, leaving two-thirds or more of the decline to increased tax avoidance in low-tax countries. The cost of tax avoidance by U.S. firms is borne by both the U.S. government and the governments of other countries. Much of Google's profits shifted to Bermuda are made in Europe; absent tax havens, Google would pay more taxes in France and Germany. (Zucman, G., Taxing across Borders: Tracking Personal Wealth and Corporate Profits, *Journal of Economic Perspectives*, Volume 28, No. 4, Fall 2014, p. 127, 129, 128 and 133).

⁶ Similar figures are advanced by Kleinbard in Kleinbard, E.D., *Through a Latte Darkly: Starbucks' Stateless Income Planning*, *Tax Notes*, June 2013, p. 1519.

[to be] equivalent to some 2.7 % of global GDP, amounting to some US\$ 1.6 trillion (€ 330 billion in the EU)"⁷. The sums of money used to fuel corruption are no less impressive. The World Bank study of 2011, the Puppet Masters, investigated 150 corruption cases. "Almost all involved the misuse of corporate vehicles, such as companies and trusts, to the tune of USD 50 billion"⁸. Also here trends are evolving in a negative direction⁹.

2. Corporate tax avoidance by multinational corporations explained

Tax has long been an area in which companies - especially multinational - could gain competitive advantage since reducing of tax burden represented a means to fulfil a duty to maximise returns for shareholders. This objective has been put in practice by creation of opaque corporate ownership structures in order to ensure that companies within a group which make profits were not visible to tax authorities in high tax jurisdictions and thus cannot be effectively taxed.

Opaque corporate structures function like pipeline through which funds can be shifted within these structures from one jurisdiction to another. Profits generated in high revenue, but usually also highly taxed countries are moved along the lines of the corporate ownership structure to low taxed countries by the help of intra-group loans, licenses, payments for use of a common software etc. As a result, the taxable income of a subsidiary is low, so this subsidiary has only a little tax to pay, even if in such a country the tax rate is relatively high. By contrast, the taxable income of a parent company in a low tax rate (offshore) country is high due to shifting of profits or other corporate funds to such company; yet, since the tax rate in the offshore country where the parent company is based is low, also this company pays only very little in corporate tax, if any.

To illustrate this point in more detail the following example can be given: a conglomerate X has two revenue making companies in two different countries whose statutory corporate tax rate is rather high (30% in Country A, 25% in Country B. These two companies sell products and

⁷ Impact Assessment Report to the proposal of the fourth Anti-Money Laundering Directive, European Commission, 5.2.2013, (SWD(2013) 21 final), p. 12.

⁸ Corporate Anonymity - Ultimate Privilege, Economist, 21 January 2012, p. 55.

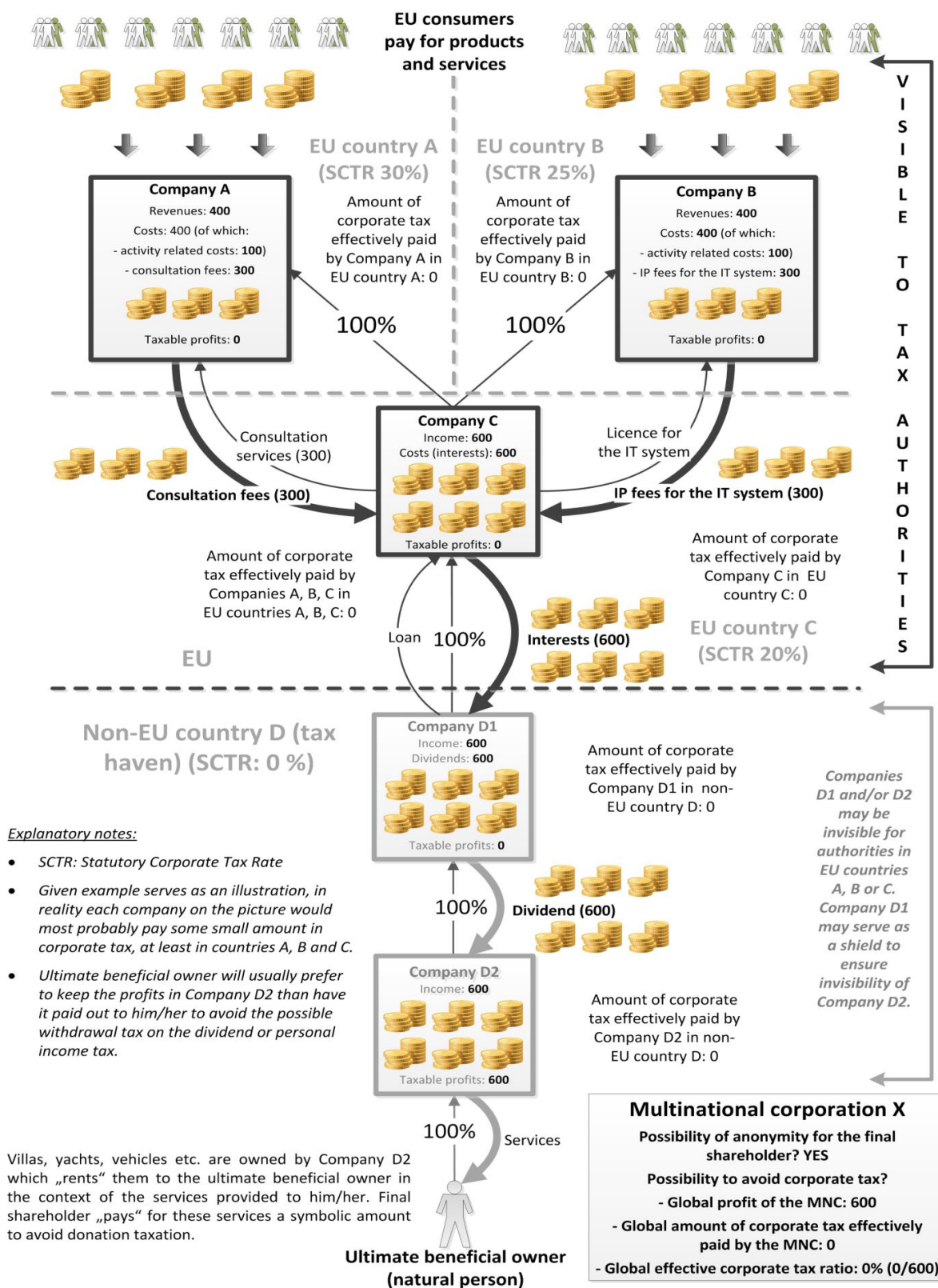
⁹ According to the World Economic Forum "law enforcement agencies have been handling an increasing number of cases in which legitimate businesses co-mingle with illegal businesses, and legitimate funds with illicit funds". (WEF, Organised Crime Enablers (2013)).

services and thus generate revenues from consumers in these countries A and B. Yet, companies A and B manage not to generate any profits which could be taxed in Countries A and B: they channel the revenues out to their parent Company C in Country C whose statutory corporate tax rate is lower (20 %).

Nevertheless, not even Company C in Country C has any taxable profits: Company C pays the amount corresponding to its incomes from Companies A and B to Company D in non-transparent EU tax haven (with statutory corporate tax rate of 5%) in the form of interests arising from the underlying loan agreement concluded between Companies C and D. However, since Company D or the interest payments made to it from Company C may be visible to tax authorities of Country C, Company D to avoid this risk transfers all its incomes in the form of a dividend to its parent Company E registered in non-transparent tax haven Country E (with statutory corporate tax rate of 0%).

Ultimately, Company E declares in Country E the dividend income from Company D as a profit: as the statutory tax rate in Country E is 0% Company E does not pay any corporate tax from these declared profits. Thus, profits generated in high tax countries A and B are ultimately shifted to zero tax Country E where they are “taxed.” Thanks to this aggressive tax scheme – which is however not illegal under the laws of any of the countries concerned – none of the companies A, B, C, D and E of conglomerate X pay any corporate tax in any country where they are registered.

Picture 1 – Illustration of a corporate tax avoidance scenario



These tax avoidance practices reduce income from corporate tax collected from multinational corporations by revenue source countries which these countries have recoup on VAT or other taxes affecting individuals.

Most of the micro- and small and medium enterprises (SMEs) cannot by their nature create complex or opaque corporate structures. Thus, they cannot hide parts of their corporate structures in non-transparent tax havens and make them invisible to tax authorities. Also, they cannot shift funds through opaque corporate structures from one jurisdiction to another. Unlike groups of companies SMEs thus do not have a possibility to avoid corporate tax in revenue source countries. As a result, SMEs can have significantly higher “tax costs” than groups of companies which makes the first them less competitive than the latter.

At the same time, if ultimate beneficial owners of companies – which in respect of companies of lower size are usually direct shareholders – must in a number of countries be public, ultimate beneficial owners of companies of larger size have the privilege to stay in anonymity. Thus, only ultimate beneficial owners of companies of smaller size have to bear responsibility for their acts performed on behalf such smaller companies whereas ultimate beneficial owners of companies of larger size, thanks to the anonymity, have a privilege to escape responsibility for their acts performed on behalf of larger companies.

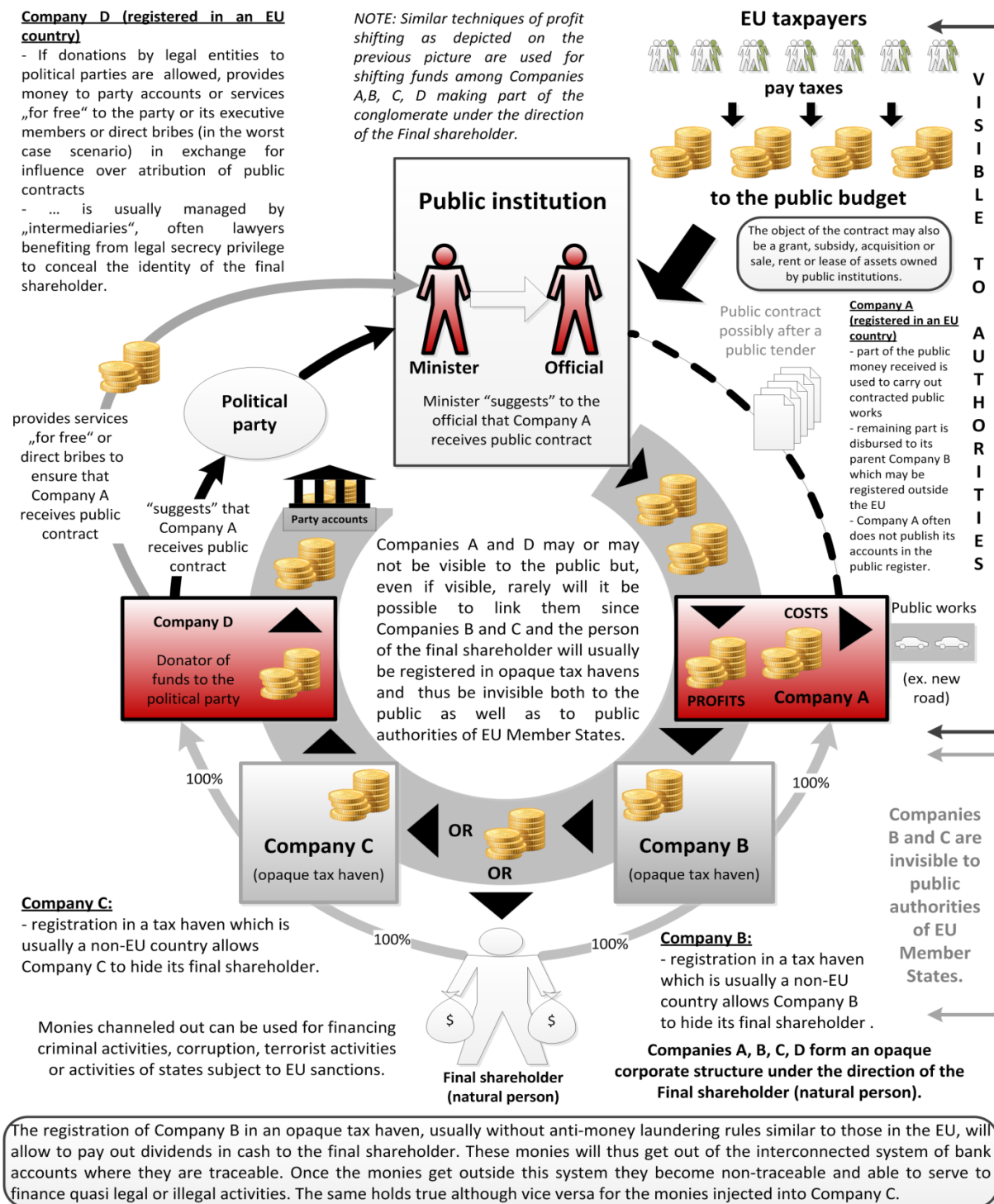
3. Ineffective law enforcement financing of economic criminality by public money, corruption and activities of states under sanctions

Lack of corporate transparency or the possibility of creating opaque corporate structures leads also to inefficient or ineffective law enforcement OECD indicates that “almost every economic crime involves the misuse of corporate vehicles [i.e. companies]”¹⁰ while the United Kingdom government documents suggest that “there is a clear link between such illicit financial flows and company structures”¹¹.

¹⁰ OECD: Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes (2011).

¹¹ Transparency & Trust – Enhanced Transparency of Company Beneficial Ownership, Department for Business, Innovation & Skills (the United Kingdom), Impact Assessment, 25 June 2014, p. 7.

Picture 2 - Financing of corruption by public money

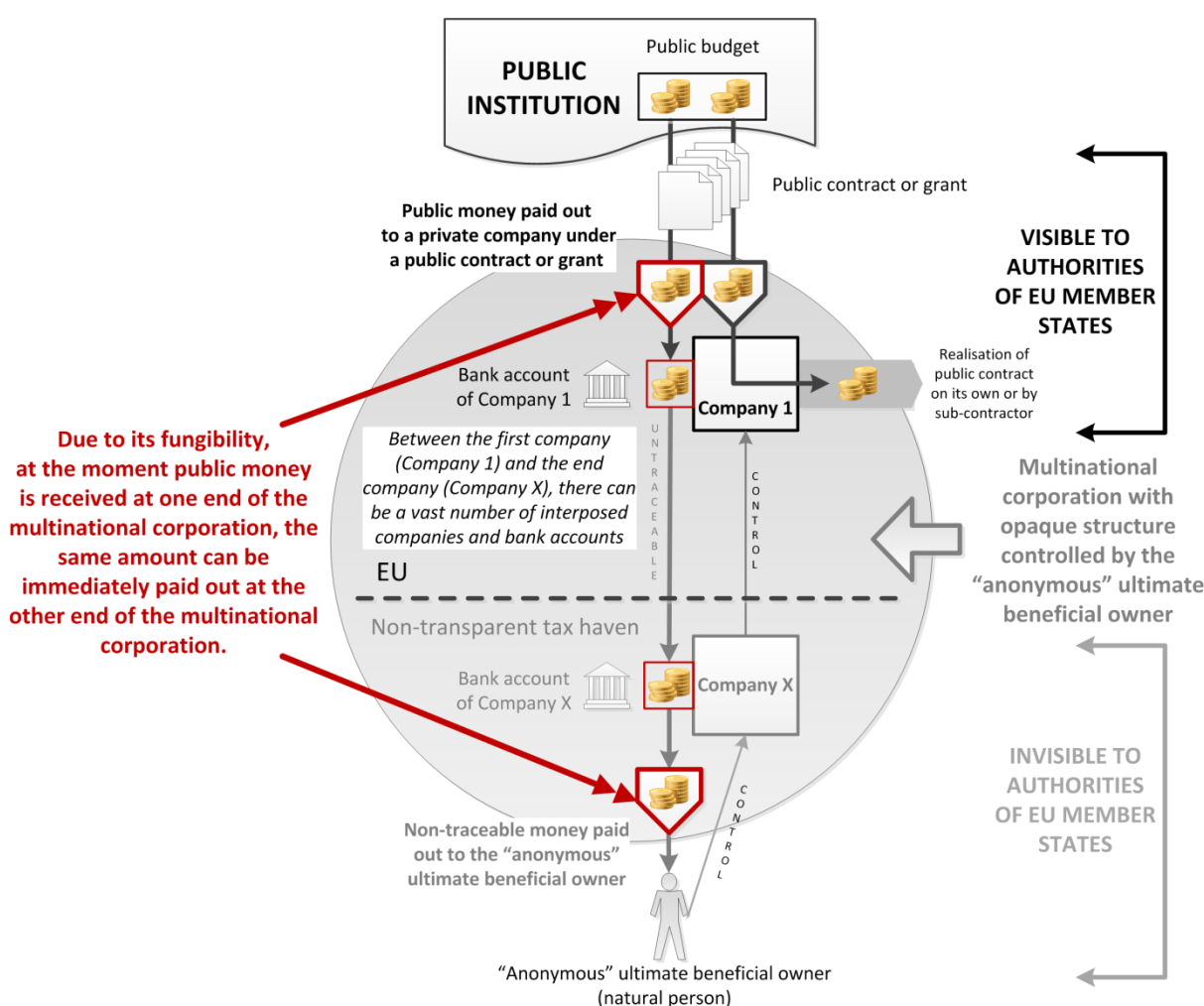


Anti-money laundering rules by their nature concentrate on the flows of money generated by criminal acts which are later “invested” in order to conceal their origin. However, anti-money laundering rules ignore reverse flows money aimed at financing criminal activities (with the exception of terrorist activities). Moreover, at least in the EU, they apply only to certain private

entities, not to public entities. "[The] definition [of anti-money laundering rules] is so narrow that it can possibly catch money generated by drugs and terrorism, but not illegitimate transactions, such as bribes, diversion of public funds to private accounts or various forms of tax avoidance"¹².

Due to the absence of effective rules requiring disclosure of corporate ownership structures of entities receiving public money, the probability of discovery of fraudulent misuse of public monies through corporate vehicles is extremely low.

Picture 3 – Financing of criminal activities through public money



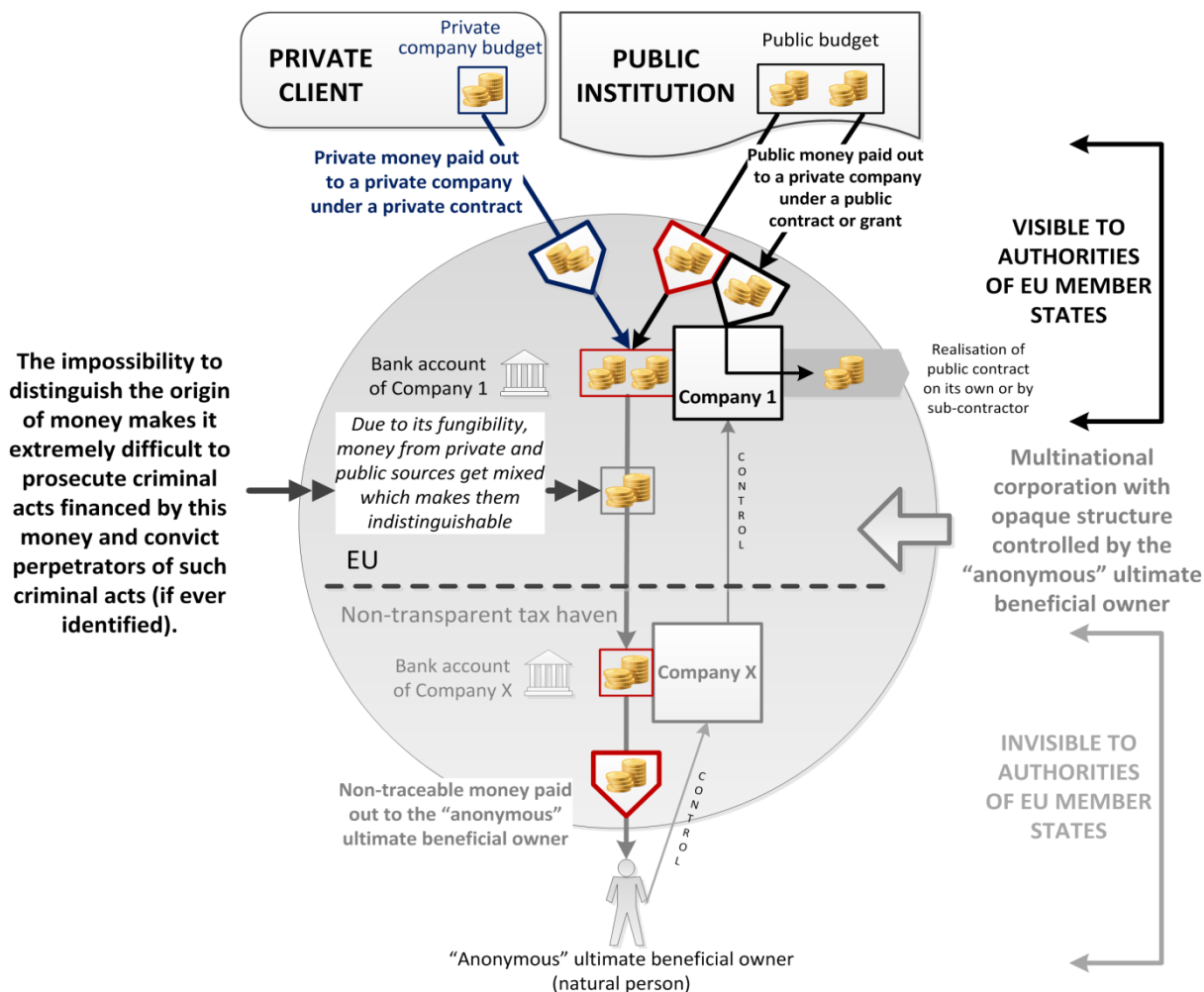
Coupled with the low cost of creation and maintenance of such structures¹³ and the

¹² Kudrna, Z., Deglobalisation 2.0 – Crisis forced multinational firms to return back to their roots, Respekt 41, 6 – 12 October 2014, p. 28.

¹³ The costs of „buying“ corporate anonymity start at EUR 1 000 per year (www.akont.cz).

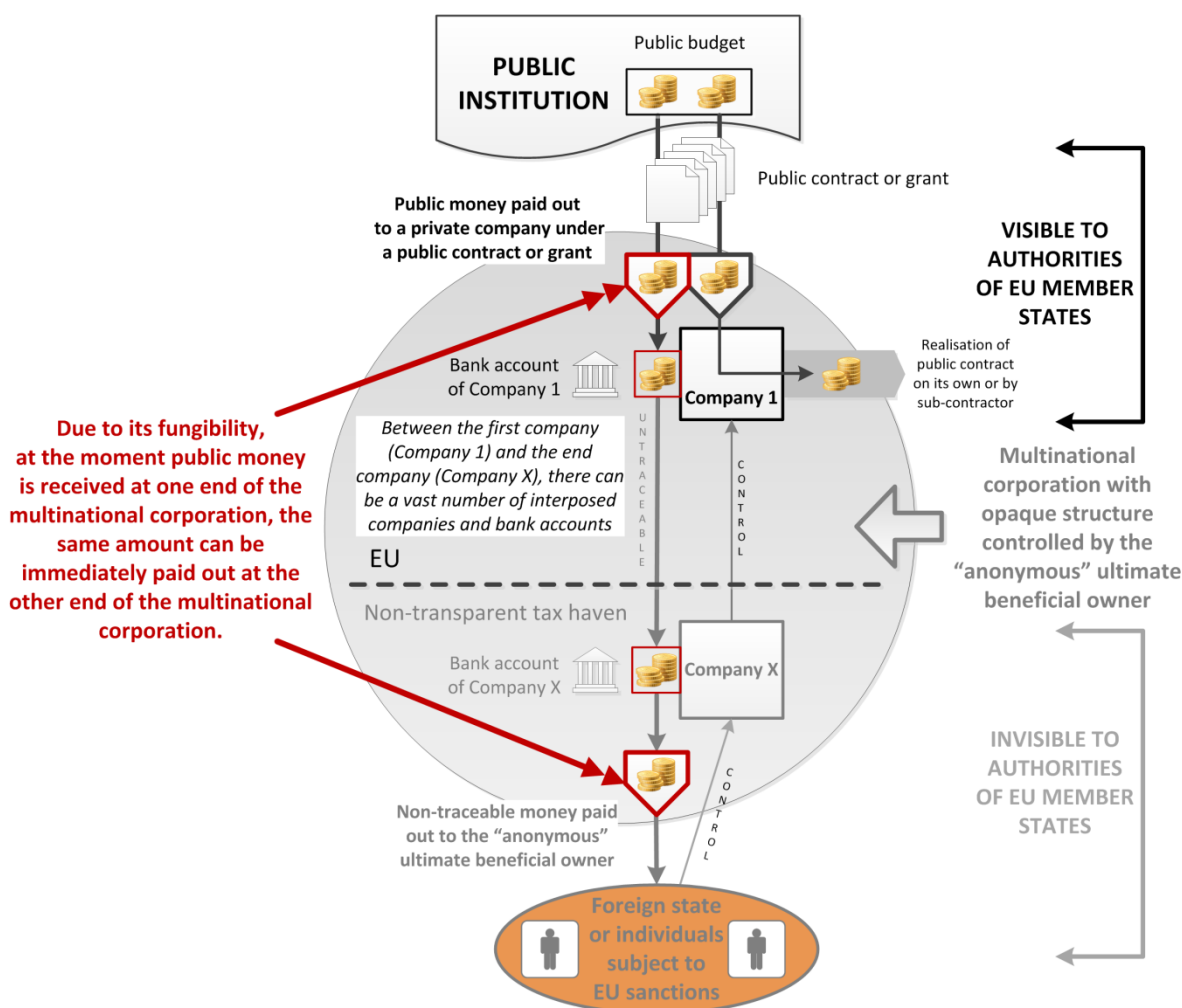
ineffectiveness of repressive bodies to prosecute and prove the existence of opaque corporate structures, diversion of public monies can prosper as a relatively safe and profitable business.

Picture 4 – Mechanism to make public money untraceable



A similar problem can be observed in respect of circumvention of international economic sanctions. Although public authorities must ensure that sanctioned persons are not involved in economic transactions, including transfers of public funds to private entities controlled by these persons, they have no or very limited means to obtain information about whether legal entities are effectively controlled or owned by the sanctioned individuals. If such a sanctioned individual owns or controls an entity receiving public money from the taxpayers, he just selects a country which does not register or communicate information about corporate ownership to authorities in the EU to avoid effects of these sanctions and continue to control or own entities receiving public money from the taxpayers.

Picture 5 - Financing of activities of individuals of third states through public funds - lack of enforceability of international sanctions



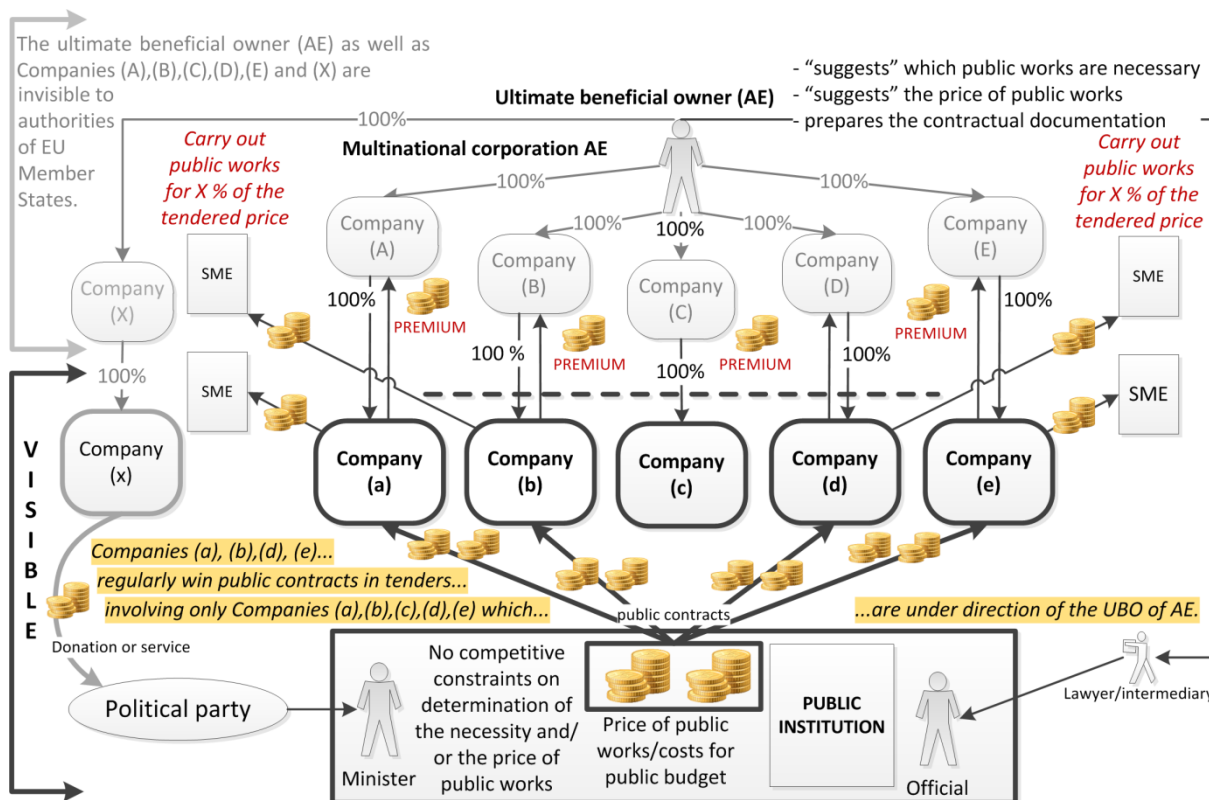
4. Inflated public spending and lack of access of SMEs to public contract and grants

Opacity of corporate ownership structures also allows entities with such structures to control access to public tenders and prevent bid rigging strategies from being discovered¹⁴. The excessive attention given to the tendering process combined with the benign ignorance of competitive structures on the market for public funds has as a consequence that by using opaque corporate structures economic operators can arrange the tendering procedure in a way that for authorities - within their limited horizon - the tender appears to be perfectly competitive whereas in reality - if the authorities were able to see the full picture, i.e. the full

¹⁴ Bueb, J.-P., Ehlermann-Cache, N., Inventory of Mechanisms to Disguise Corruption in the Bidding Process in Fighting Corruption and Promoting Integrity in Public Procurement, OECD Publishing (2005), p. 173.

competitive structure – they would see that the market is, by contrast, perfectly rigged or abused.

Picture 6 - State capture of a public institution by a company receiving public funds with anonymous ultimate beneficial owner

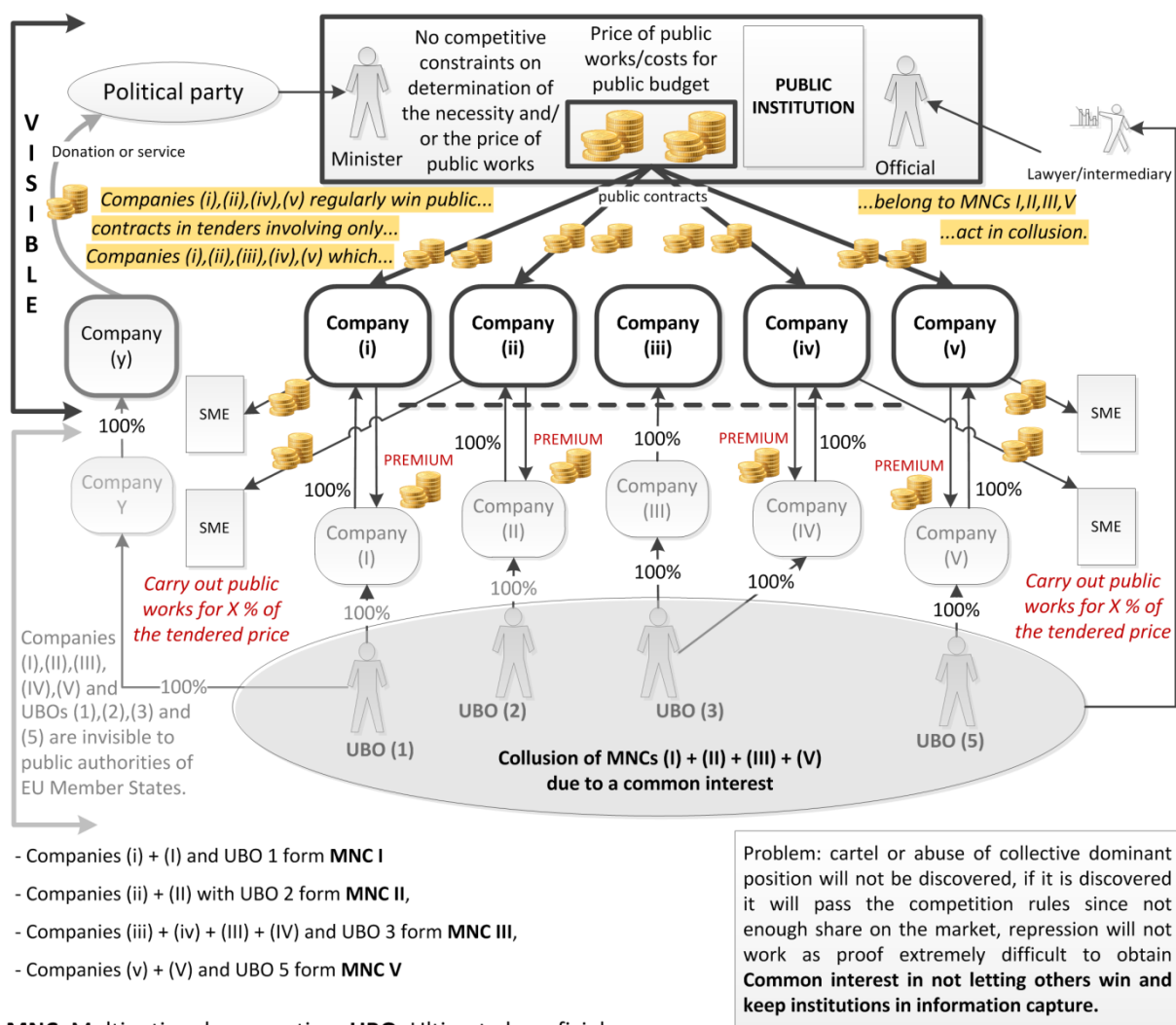


The diagram refers to the so-called vertical silo situation. In this situation a non-competitive company on the standard market is able to have a monopoly on certain specific part of the market for public funds, for example, a provider of an IT-system to a ministry or state agency. The company manages to monopolise IT contracts attributed by the ministry by the following means: (i) it provides sponsorship to the party controlling the ministry or state agency, (ii) arranges the tendering procedures in a way that in the statistics it looks as if there were a perfect competition, (iii) indicates to the authority which public works it needs as well as its price, (iv) prepares contractual documentation for the public contract, (v) tries to agree with SMEs that they do not compete in public tenders (in order not to bring the offered price down) and in exchange sub-contracts to these SMEs parts of the attributed public contracts.

Those barriers again mainly affect micro- as well as small and medium-sized enterprises which, as a result, are not able to obtain public contracts or grants. Preliminary research findings of

SpendNetwork, NGO following over 20 years government data in the United Kingdom suggest that in the UK the government spends between 3% and 4% of their total spend with companies that are less than 3 years old. Of this spend less than 10% is with small companies (startups). So as a start-up, you've got a 0.3% chance of winning any government business, and this includes 'start-ups' that are three years old. Most of the spend goes to large companies who set up new companies for administrative purposes¹⁵.

Picture 7 - State capture of a public institution by collusion of companies receiving public funds with invisible ownership structure



The scenario in Picture 7 refers to the recently famous Czech “Rath corruption case”. In relation to the public building contracts granted by the Region of Central Bohemia governed by David

¹⁵ Interim evidence from the on-going SpendNetwork project on public procurement in the U.K.

Rath, former minister of health, currently facing a trial before the Regional Court of Prague, the following rigging method was used: the competition for the building contracts was only arranged, the companies in the tender acted in collusion: according to the accusation plea of the state prosecutor the accused perpetrators were organising meeting in which they were agreeing which companies will submit tender offers and then which company will win in which tender. A similar scheme was used also in public contracts in other hospitals of the Central Bohemia region. Following this corruption case the European Commission stopped all financing from EU funds to the Region of Central Bohemia.

5. Conclusion: No effective countermeasures developed so far

Corporate tax avoidance, diversion of public money and state capture run little risk of being discovered and punished when carried out through opaque corporate and tax structures since even the richest states have currently little capability of developing a big picture of global value chains. A *“mechanism [to] track and expose those who aren’t paying their fair share”*¹⁶ has not yet been developed.

The aggressive tax planning practices do not only shrink incomes of states from corporate taxes, but they also discriminate against micro- as and small and medium enterprises. Finally, the possibility for groups of companies to conceal parts of their corporate structures, including their ultimate beneficial owners, also raises the question of liability for the acts of those companies since thanks to the complex structures those persons who ultimately control these companies, their ultimate beneficial owners, cannot be traced down and, thus, can evade civil or criminal liability.

¹⁶ David Cameron in G8 leaders promise corporate tax clampdown to bolster economies, Financial Times, 19 June 2013, p. 3.