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Are Tax Havens Still Worth The Risk?

Increased scrutiny over tax havens

Questions surrounding tax havens and profit shifting have existed for some time now. The fundamental question that needs to be answered by taxpayers situated in multiple jurisdictions however is whether the utilization of tax havens in any legitimate business model is worth the risk? This is especially true considering that tax havens are facing increasing scrutiny as time progresses.

In March 2019, the European Union (EU) unveiled an updated list of tax havens, blacklisting additional countries in order to discourage taxpayers from using these jurisdictions for profit shifting purposes. The blacklisted jurisdictions are now facing damage to their reputations as legitimate places of doing business and would be subject to increased scrutiny by EU regulators and tax administrators. The most surprising addition to the list has to be the inclusion of the United Arab Emirates (UAE), which created somewhat of an uproar among EU member states, with some arguing that the UAE's inclusion was not warranted.

Hence, it does appear that whilst countries are trying their level best to reform their tax systems (as is the case with the UAE), zero-to-low tax regimes are still faced with the risk that taxpayers might be dissuaded from doing business or shifting their profits to these tax jurisdictions in view that their transactions might be scrutinized even further by tax administrators in their respective countries.

The whole issue surrounding the EU's inclusion of additional countries to expand the list of tax havens begs the question as to whether doing business with such jurisdictions needs to be managed more effectively from a tax perspective. Is the increased scrutiny worth the benefits of lower corporate income tax rate in this day and age?

Tax havens: Advantage or Risk?

Academically, it’s been well established that tax havens are jurisdictions which have a zero or low-to-zero tax rate. However, it is also well noted that tax havens, by virtue of their low-to-zero tax rates have attracted much foreign direct investments. The UAE is a classic case in point. Being the Arab world's second largest economy and a federation of some of the world's richest states with high amounts of capital, businesses that do not wish to operate in this region might be foregoing a huge payoff despite the country's tax haven characteristics.

A clear example of this is that in 2018, Dubai ranked 3rd in the world for greenfield foreign direct investment projects (specifically in the medium to high technology sector), attracting investors from the United States, India, Thailand, Spain and the United Kingdom. As such, would Dubai, a key component of the UAE, witness reduced foreign direct investments (FDI) simply because it is now considered a blacklisted tax haven? I would hardly think so.

Hence, from a FDI perspective, being a tax haven has its clear commercial merits. That being said, artificially setting up complex global corporate structures to merely take advantage of the supposed tax haven benefits is another matter entirely.

Taxpayers around the world should take heed of the on-going global effort to stamp out such practices. They should ensure that any business transactions with these countries would yield positive commercial outcomes instead merely taking advantage of tax benefits as the risks associated with these practices might be too high to ignore given heighted global cooperation on this issue.

Three examples come to mind. The first being that changes in U.S and EU policy have spurred the developments of these global initiatives in combating the act of tax evasion using tax havens. Continual efforts by both of these major economic blocks in the form of enhanced regulation, updated guidance and increased public consultation on BEPS related initiatives have started producing results. As one author puts it:

> *"Tax evasion and asset secrecy may finally be yielding to effective international cooperation*
>
> *(Kurdle, 2016)"*

The second is that there appears to be empirical evidence of firms within EU tax jurisdictions scaling back their profit shifting activities through reduced participation in known tax havens. In a recent 2018 study published by Saxunova and Szalai of Comenius University in Bratislava, Slovakia, the authors noted that the number of companies within the Czech Republic that parked profits in tax havens had decreased from 13,419 companies in 2015 to 13,031 companies in 2017. In addition, the growth rate of Slovakian companies booking profits in tax havens since 2015 has also slowed. Hence, it does seem that taxpayers within EU states are taking serious notice and are starting to feel the effects of the increased scrutiny being placed on tax havens.

The third example centers on Labuan, a Federal Territory in Malaysia. During the 1990s, Labuan was considered to be a territory with tax haven like characteristics. Labuan based entities are treated differently as compared to other entities operating in Malaysia. Companies incorporated in Labuan that carry out specific business activities in, from or through Labuan, can elect to either pay a lower preferential corporate tax rate of 3% of its audited net profits or a fixed tax of RM 20,000.

Examples

In 2019, the Malaysian government enacted legislation to reform the Labuan tax system. This included amendments to existing laws to remove the fixed tax option, introduce a cap on allowable tax deductions and requiring income derived from intellectual property assets to be taxed without preferential treatment. Further, new Substance Regulations were also introduced, making it mandatory for Labuan entities carrying on any Labuan business activity to maintain a minimum number of full time employees and annual operating expenditure.

Such initiatives by the Malaysian government seem to be aimed at reducing the potential abuse of the territory for profit shifting activities whilst attempting to maintain Labuan's attractiveness as an investment destination for foreign companies. It is also noteworthy that such reforms were introduced by Malaysian tax authorities less than 2 years after Malaysia's commitment to the BEPS Inclusive Framework, which appears to be a proactive response in view of the heightened international scrutiny on jurisdictions with tax haven characteristics.

The three points outlined above are indicative that global cooperation and the 2015 BEPS initiative are yielding measurable results in certain tax jurisdictions. It is not unreasonable to assume that taxpayers and tax administrators in other tax jurisdictions around the world are moving in tandem with these global trends. This is an encouraging outcome and global tax policy setters must continue their efforts to ensure that tax havens' role in profit shifting is steadily reduced, up until a point where utilization of such jurisdictions in global tax structures becomes disadvantageous to most multinational enterprises.

To answer the question plainly - are tax havens still worth the risk? Yes and no. My personal view is that as long as multinational enterprises have legitimate and commercial benefits from participating or investing in tax havens, operating in such jurisdictions might still be worth the risk. But as always, risks require significant mitigation and taxpayers should work towards ensuring that any potential corporate structures are not crafted for the purposes of profit shifting, but have clear and viable business merits capable of withstanding scrutiny on a global level.

by Kishenjeet Dhillon, 22 March 2019
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Disclaimer*: Aside from those mentioned above, where applicable, references have also been made to applicable legislation, regulations and guidelines thereunder with respect to the tax jurisdictions mentioned in this article.*

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