

## **A GLIMPSE INTO THE OFFSHORE WORLD AFTER “PANAMA PAPERS”**

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### **Abstract:**

*In the light of the latest leak of offshore documents, Panama Papers, the purpose of this article is to analyse a set of data made available, that reveals important information on the offshore world and the mechanisms by which it functions. There are identified the main business structures and tax benefits that are offered under the Panamanian legislation, as well as that of other offshore jurisdictions that are being used in the construction of tax planning schemes aimed at obtaining important tax benefits. The results of the analysis present interesting findings regarding the offshore financial services industry, the intermediaries involved in the structuring of tax planning schemes and the most commonly used offshore jurisdictions in tax structuring plans.*

**Keywords:** *Panama Papers, Offshore industry, Tax planning, Business structure*

**JEL Classification:** *H 87, K 34*

### **INTRODUCTION**

Following the “LuxLeaks” project (ICIJ, 2014) from 5 November 2014, which looked into the tax affairs of multinational companies, the “Panama Papers” project (ICIJ, 2016) offered a glimpse into the offshore world, which brought forward new information on the tax planning schemes and tax advantages made available through a network of jurisdictions. A prime notice on this offshore - data release project was that the tax planning arrangements were lawful and no breach of law was encountered. All the business structures: offshore companies, foundations and trusts were legitimately set up based on local legislations and the tax advantages obtained were supported by the local fiscal codes.

Although there is no generally accepted definition of an offshore jurisdiction, a compilation of reports and analyses performed by

international organizations, such as the OECD, IMF, FSF, etc. present these jurisdictions as states and/or territories which have developed important financial industries due to the tax advantages presented and which offer services to non-residents (natural or juridical persons) with the aim of reducing their total tax burden (OECD, 1998; IMF, 2000; FSF 2000)

Yet, concerns regarding the erosion of national tax bases caused by the artificial shift of profits have led to the latest OECD's project "Base Erosion, Profit Shifting (BEPS)" which focuses on multinational companies' taxation, with the aim to target tax avoidance and to ensure that taxes are paid where the economic activities take place (OECD, 2013b). Harmful tax measures are targeted under Project's Action 5, by means of improving transparency and requiring substantial activity (OECD, 2015). The measure is also supported by the European Union through the Action Plan "Fiscalis 2020" that addresses aggressive tax planning through a number of measures that need to be considered: a coherent Union law in the field of taxation, enhanced administrative cooperation and capacity of tax authorities (The European Parliament and The Council, 2013).

This paper aims to analyse a set of data extracted following the release of Panama Papers project in order to reflect on the internal mechanisms that function in an offshore jurisdiction and the connections that are established with other states in the construction of the tax planning arrangements. The paper presents the particularities of the Panamanian business and tax legislation as well as that of other offshore jurisdictions closely linked in the tax planning structuring schemes, as revealed by the report. A set of graphics are explained in connection to the tax rationale of the offshore service providers. The results of the analysis present a set of interesting aspects which link offshore jurisdictions, tax advantages and intermediaries that design tax planning solutions.

The first part of this paper presents the literature review in the area of tax planning and tax avoidance, a topic of concern brought at a worldwide level. The second part presents the methodology of this research, where there are presented the particularities of the Panamanian tax and business laws and that of other offshore jurisdictions closely linked in respect of tax planning arrangements. This section also presents a set of graphics extracted from the Panama Papers Project which are interpreted in the light of the tax planning arrangements. The third part of this paper presents a summary of the main results obtained, followed by conclusions.

## **1. LITERATURE REVIEW**

The Organization for Economic Cooperation and Development (OECD) recognizes taxation as one of the main components of profitability,

hence having the potential to influence the decision on the location and the mean of investment (OECD, 2013a).

Taxation was given the attribute of a motivating factor in corporate decisions (Lanis and Richardson, 2012) and aspects related to financial options, organizational forms, restructuring decisions, payout policies, etc are strongly influenced by taxes (Desai and Dharmapala, 2006).

Taxation may be considered a cost for the company and in this respect the managers strive to run their business in the most cost effective manner (ACCA, 2014). In this context, the managers may be tempted to consider tax planning schemes aimed at diminishing the level of taxation.

Tax planning may be considered as comprising of all activities designed to produce a tax benefit (Wahab and Holland, 2012). In this respect, if tax is seen as a cost for the company, managers will try to minimize it to the extent it is legally and socially acceptable (Garbarino, 2011). Besides tax planning benefits translated in reduced tax liability, there are also considered the costs associated to tax planning activities. Therefore, tax planning activities may increase the after tax profits, yet they involve actual and potential costs that may diminish the benefits they provide (Wahab and Holland, 2012; Garbarino, 2011). The actual costs may consist in the fees or salaries paid to tax consultants, while the potential costs may be reputational costs or those that may arise in cases where the tax strategy would be challenged by the tax administration (Wahab and Holland, 2012).

Corporate tax strategies may also be classified as aggressive or responsible. On one hand, aggressive tax planning may be defined as a corporate effort to minimize tax liability by all the possible legal means. On the other hand, responsible tax planning is the strategy that complies with the intention of the law and does not try to exploit all legal possibilities to diminish tax (Hardeck and Hertl, 2014).

Considering tax as a motivating factor in many corporate decisions, managerial actions designed solely to minimize tax liability through aggressive tax planning are becoming a reality of the corporate global environment (Lanis and Richardson, 2012; Desai and Dharmapala 2009).

A distinction in terms of the “letter of law” and the “spirit of law” is translated in two different concepts: tax avoidance and tax evasion (Hasseldine and Morris, 2013). Although both actions imply reducing the tax burden, tax evasion is an illegal activity, while tax avoidance is legal (Freire-Serén and Martí, 2013).

Lately, tax avoidance has entered public attention and considered socially unacceptable (Frank Mueller, 2015). An emphasis has been placed on the need for the multinational companies to pay the fair share of tax where the economic activities are conducted.

Corporate tax avoidance is a critical aspect on the international political agenda as the tax related affairs of prominent multinational companies have raised hostility from civil society and non-governmental organizations. Hence, the need for action on behalf of the policy makers is critical (Jones and Temouri, 2016).

## **2. METHODOLOGY**

In the light of the new tax related project into the offshore world, “Panama Papers”, this study aims to perform an analysis on a set of data that looks into the offshore tax systems and the relations between them in the construction of tax planning schemes. First, we consider the tax and business legislation of Panama and then we perform an analysis on a set of graphs that explain the network of intermediaries and other jurisdictions involved in the equation of the tax planning schemes, according to the information released in the “Panama Papers” Project.

### **2.1. Panamanian tax system and business structures**

In spite of a corporate tax rate of 25%, Panama has in place a territorial tax system under which both residents and non-residents are taxed only on the income sourced from Panama. Revenue that is sourced from another jurisdiction is not subject to taxation in Panama (Deloitte Panama, 2016). This system represents a key tax advantage for non-residents that establish companies in Panama and derive income from activities conducted outside this state.

Companies that are resident in Panama for tax purposes must withhold tax on the distribution of dividends at the following rates: 10% for dividends that arise from activities conducted on the territory of Panama and 5% for dividends that arise from activities conducted outside Panama or repatriated. Also, withholding tax apply to interests and royalties paid to non-residents at a rate of 12.5%. Capital gains are taxed at a rate of 10% (Deloitte Panama, 2016).

Tax incentives, translated into lower tax rates apply as well to the investments that are made in Panama. The Howard Special Economic Area provide for a special tax regime that apply to offshore activities and other transactions between companies within this area (Deloitte Panama, 2016).

Therefore, a prime tax advantage offered by Panama is the territorial tax system, where the income of resident companies sourced from abroad is tax exempt.

A company is resident in Panama if it is incorporated under the law of Panama, or if it is centrally managed and controlled from Panama. The

main types of companies are: the corporation, the limited liability company, the general partnership and limited partnership (Deloitte Panama, 2016).

It can be noticed that the business law of Panama does not provide for offshore company incorporation, but instead the territorial tax system in place brings similar tax advantages, by means of foreign income being exempted from tax.

## 2.2. An explanation to the data sourced from the “Panama Papers”

Within this subsection we focus on a set of data extracted from the “Panama Papers” Project with the aim to find an explanation on aspects related to the functioning of an offshore mechanism. The data was presented in the “Panama Papers” documents and they related to the activities conducted by the legal services provider Mossack Fonseca for its clients. A number of aspects presented reveal on the mechanisms being used in the offshore business sector.

There have been selected three key areas in order to be analysed: the company incorporation evolution during 2005-2015; the most prominent countries where intermediaries operate and the most popular tax havens that have been used in the tax planning schemes.

- *Company incorporation evolution between 2005 and 2015*

Figure 1 presents the evolution of the Panamanian companies incorporated by the legal services provider Mossack Fonseca since 1977.

The evolution of the Panamanian company incorporation process is being analysed during a time span of 10 years: the peak of company incorporation in 2005, a steep decline between 2008 and 2009, stagnation between 2009 and 2012 and a further decline until 2015.

While in 2005, the number of company incorporations reached the peak of 13.287, a significant decline of 15.5% in the number of companies incorporated was registered between 2007 and 2008, with a further decrease of 21.49% between 2008 and 2009. This decline may be associated with the global financial crises which has propelled destabilization of businesses in this area as well.

Stagnation was registered between 2009 and 2012, where on average the number of companies incorporated was 8566. This period was followed by a further decline of 48.40% in the number of companies incorporated between 2012 and 2015.

Figure 1. Offshore companies incorporated by Mossack Fonseca since 1977



Source: (ICIJ, 2016)

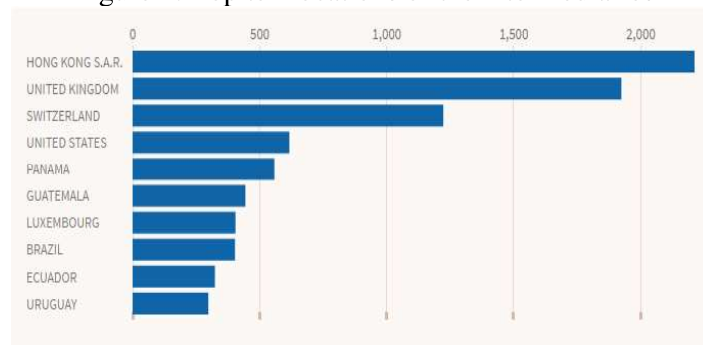
The constant decrease in the number of companies incorporated by Panamanian legal services provider Mossack Fonseca starting in 2008 and continued until 2015 may be attributed to the effects of the financial crises.

Records also indicate on the short life span of offshore companies that stay active for a limited number of years.

- *The locations where the intermediaries operate*

The design of the tax planning schemes are not created in isolation to other jurisdictions but, as revealed in the Mossack Fonseca's documents, there is a wide network of intermediaries that have their roles in the structuring of tax efficient schemes. Figure 2 presents the main locations where the intermediaries operate.

Figure 2. Top ten locations of the intermediaries



Source: (ICIJ, 2016)

From the jurisdictions presented in Figure 2 as locations with active intermediaries, we can identify in the first four positions, three leading global financial centres: Hong Kong, London (United Kingdom) and New

York (United States), according to the Global Financial Centres Index 19. Geneva (Switzerland) and Luxembourg remain leading financial centres in Europe (Z/Yen Group, 2016).

Three of these jurisdictions, Hong Kong, Switzerland and Luxembourg present interesting particularities in terms of tax systems, characterized by numerous tax advantages.

Hong Kong has a territorial tax system, where tax is levied only on the income sourced from Hong Kong. The general tax rate applied on profit is 16.5%, while the income generated outside Hong Kong is tax exempt. Also, there is no withholding tax on dividend and interest distribution from a Hong Kong company (Deloitte Hong Kong, 2016).

Switzerland has in place a global tax system, yet profits derived from foreign branches are tax exempt. The effective income tax rate ranges between 12%-24% (which encompass both the federal tax and cantonal tax), depending on the canton where the company is registered. Important tax incentives are granted to holding companies and to mixed companies.

The holding company regime provides for a full exemption on cantonal taxes. The main statutory purpose of a Swiss holding company has to be the holding of participations and it should not conduct any business or trade in Switzerland.

Mixed companies with predominantly foreign business activities (at least 80% of the total gross income is foreign-sourced and at least 80% of expenses are incurred abroad) enjoy a special tax regime. The effective tax rate applied to a mixed company ranges between 9% and 11%, including federal tax (Deloitte Switzerland, 2016).

Luxembourg provides for tax incentives in respect of dividends and capital gains received by a qualifying entity from a qualifying shareholding. In order to be tax exempted the qualifying entity must hold the participation, directly or indirectly, for an uninterrupted period of at least 12 months and it must account for at least 10% or to have been purchased for a price of at least EUR 1,2 million.

The Luxembourg tax system does not impose withholding tax on interests and royalties, as well as on the dividends paid to a qualifying entity under the EU parent-subsidiary directive (Deloitte Luxembourg, 2016).

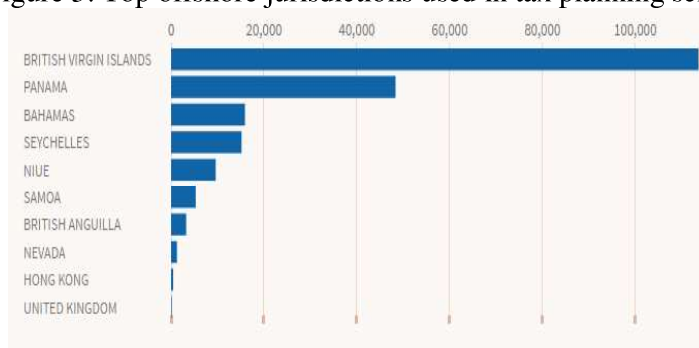
It can be observed that the top intermediaries are major international financial centres, as well as locations that present important tax advantages which may be included in tax planning schemes.

- *Offshore jurisdictions used in tax planning schemes*

The construction of tax planning structures involves a network of tax efficient systems offered by a number of offshore jurisdictions. As

presented in Figure 3, the British Virgin Islands is the most frequently used jurisdiction in the tax planning schemes. Tax advantages presented by Bahamas, Seychelles, Niue and Samoa are used at a lesser extent.

Figure 3. Top offshore jurisdictions used in tax planning schemes



Source: (ICIJ, 2016)

All these listed offshore jurisdictions present their particularities in respect of their tax systems and business structures that raise a number of advantages.

The British Virgin Islands and The Bahamas distinguish in the offshore landscape by means of a general zero-rate income tax regime applicable to both natural and juridical persons. This represents a key advantage that has been exploited in the tax structuring schemes (Deloitte BVI, 2016; Deloitte Bahamas, 2015).

Seychelles is a representative offshore financial centre in the Indian Ocean. The corporate tax rate is 25% on the first SCR 1 million (approximately EUR 66.626) and 33% on the remainder (Seychelles Revenue Commission, 2016). Yet, the Seychelles IBC Act provides for the incorporation of the classic offshore company, the International Business Company which is not subject to any tax as long as it conducts activities outside Seychelles. An IBC shall not carry any business activities or own properties in Seychelles. This type of company is the most commonly used vehicle for obtaining tax exemption facilities (Seychelles IBC Act, 2014).

Located in the Pacific Ocean, Samoa has in place the International Companies Act, which provides the framework for incorporation of the International Company (Samoa IC Act, 2009). While prohibited from conducting any kind of business in Samoa, the income generated by the International company from abroad benefits for total tax exemption (SIFA, 2016). Niue, on the other hand does not provide any tax exemption facility, as in 2006 its offshore legislation was repelled (OECD Niue, 2016).



The tax facilities offered by the British Virgin Islands explain the predominant use of this jurisdiction in the tax planning schemes developed by the Panamanian legal services provider Mossack Fonseca, while being revealed a practice which may be a custom in the offshore world.

### **3. RESULTS**

The data analysed in the second section of the paper is extracted from the “Panama Papers” documents and it presents information related to the activities of the Panamanian offshore service provider Mossack Fonseca. The information obtained is extrapolated to the offshore sector, given the fact that the mechanisms used in achieving tax efficient structures may follow similar patterns in the offshore world.

Following the analysis presented in the second section of the paper, we may conclude on a set of aspects which relate, by extension, to the tax planning practices from the offshore industry.

First it can be noticed a severe decline in the number of offshore companies’ incorporations starting from 2008, which may be explained by the propelled effects of the financial crises. Therefore, it may be concluded that besides the short life span of an offshore company, the number of new companies incorporated has diminished substantially in the past eight years.

A second aspect identified relates to the locations of the intermediaries involved in tax structuring. Within the first four positions of the ranking, three locations are recognized as leading global financial centres: Hong Kong, London (United Kingdom) and New York (United States). Geneva (Switzerland) and Luxembourg, two leading European financial centres, are also locations with active intermediaries in the tax planning structuring. This may indicate on the fact that the tax planning schemes are not constructed in isolation, being limited to only one jurisdiction, but they are constructed using a wide network of tax systems.

The third aspect reflected upon was the construction of tax planning arrangements which involved a network of tax efficient structures offered by a number of offshore jurisdictions. The British Virgin Islands is the most frequently used jurisdiction in the tax planning schemes. Also, tax advantages presented by the Bahamas and Seychelles are considered in the tax structuring process.

The set of aspects focused upon reveals some facts regarding the offshore industry in terms of the network of intermediaries and other offshore locations being included in the tax planning schemes.

## CONCLUSIONS

The “Panama Papers” project offers a glimpse into the offshore world by revealing a panorama of mechanisms and functions that are used in the construction of the tax planning structures. Starting with the analysis of data related to the Panamanian offshore service provider Mossack Fonseca, we reached an understanding of the framework in which the offshore industry functions. With a territorial tax system in place, Panama presents substantial tax incentives to the companies that conduct business activities abroad. In addition, the number of intermediaries located in leading financial centres creates a vast network of both clients and options for the structuring of tax efficient schemes. Also, the structures are complemented and/or completed by tax advantages offered by other offshore jurisdictions. In this respect, the British Virgin Islands is the most frequently used jurisdiction in tax planning arrangements.

The results obtained following the analysis of the newly released set of data presented under the “Panama Papers” project emphasize on some key aspects that characterize the functioning of the offshore centres and their tax structuring schemes. The understanding of the offshore industries’ mechanisms may lead to the creation of policies and action plans that are to target different areas of concerns being currently raised in the international context of tax competition and tax avoidance.

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