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Looking for a Tax Break Offshore: A Primer on Tax Havens and Offshore Accounts

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There has been a lot of talk about taxation fairness in certain circles of late. As individuals and corporations hunt to lessen their tax burden, grumblings of "offshore" holdings have made their rounds in the media. The Panama Papers, the Paradise Papers and the portrayal of the resentment and envy they engender have given us glimpses into this world but how did the disparity come about and who are the players that drive this multitrillion dollar global industry?

Tax Burden or Tax Incidence

Before we can talk about tax avoidance, we need to better understand what we're trying to avoid. Taxation seems pretty easy to understand. Although relatively intuitive, there is more math to taxation than simple percentages and the value at which goods and services are taxed has predictable results on sales and revenue. Remember the supply and demand curve? It is a fundamental principle of economics but how can it shift with taxation? Simply stated the smaller the supply, the greater the demand and the higher the price. Taxation changes the absolute value paid for an item and influences supply and demand.

Understanding taxation through the supply and demand curve introduces us to the concept of a "shared tax burden." An example is helpful to the explanation. Imagine a company making widgets and a government that needs more money. After much study, the government decides that taxing the widget sector makes good political and financial sense. At first glance it would appear the entire percentage levied makes it way to government coffers at the expense of the consumer, but this isn't quite the case.

There is a supply and demand curve shift: the absolute cost increases and there is a predictable drop in demand. As demand falls, the company's revenue and profit drops. When sales volume falls, the taxation revenue drops as well. The company makes less money and the government collects less tax. The company and government are said to share the cost of the tax or share the tax burden. In reality, more than just those 2 players share the burden: The company will pass on the drop in profit to its employees by dropping wages or hiring fewer workers and the government will pass on the decreased revenue to its citizens by increasing personal or sales tax or decreasing its support of social programs.

Tax planning can be crucial for an international company trying to squeeze margins and increase shareholder value. In their quest to increase profits or decrease costs, companies hunt for legal means to lessen their tax burden.

Tax Havens

By simplest definition, a tax haven is a geographical area where the rate of taxation is lower. Jurisdictions may vary in the extent of protection they provide to that end for the corporation or individual. Lower income tax rates, no inheritance tax, legislative laxity and financial secrecy are just a few opportunities that exist. Regulation in these jurisdictions is purpose designed to attract clients from the global tax burden avoidance pool.

Origin of Tax Havens

On the basis of the tone used in the lay press, it would be easy to assume tax havens arose from nefarious origins, but in reality, these came into existence purposefully as a result of politics and policy. In the years that followed the First and Second World Wars, tax havens either grew out of economic change or were created to achieve political objectives.

Switzerland is commonly referred to as the first tax haven; as of World War 1 neutral Switzerland was able to avoid the massive payback taxation hikes that followed the war. With an established financial industry known for stability and

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discretion, Switzerland saw large influxes of capital taxed at lower rates.

These early offshore shells had one focus: wealthy individuals seeking wealth preservation. Progressive taxation—where the wealthy pay more tax—was almost unheard of prior to the war but became commonplace in the years that followed and personal tax rates jumped from single digits to almost 30% throughout Europe for the well to do as countries struggle to pay back war debt. The money didn't flow to the tropics; the common destinations of the day included Jersey, the Isle of Man and Ireland.

In the years that followed World War 2, this cottage industry would become a financial juggernaut. The waning British Empire struggled to shed the economic dependence of its remaining colonies and granted tax exempt status to a number of small islands laying the groundwork for the industry we know today.

Following the war, countries had all agreed to restrict foreign investment in order to lessen their respective outflows of capital. Britain, faced with a financial crisis in the 1950s, further clamped down on this policy to save the plunging sterling pound and their plan was met with an uproar. Investment banks relied heavily on foreign forays and protested vehemently. Their concerns were acknowledged and placated. The British Parliament lifted the foreign investment restrictions as long as the banks met 2 conditions: transactions could not be executed in British sterling and the parties involved in the deals could not reside in the United Kingdom. It may not have been the best thought-out plan. Unlimited transactions could be executed, but they no longer occurred in the United Kingdom. In fact, they now occurred nowhere and most importantly under the auspices of no government, no regulators, and no revenue agencies.

London became the financial hub for international business much to the chagrin of Wall Street. It became far easier to execute US dollar business in the United Kingdom without the usual hassles of US taxation and regulation. By the time the United Kingdom understood what they had done business was booming, the colonies were financially independent and it seemed like bad business to shut the whole thing down.[1]

How Much Money Are We Talking About Here?

No one knows for certain how much is tied up in offshore accounts. Multiple models have put forward many estimates which vary from 8% to 10% of invested global wealth or 10% of global gross domestic product (GDP). Conservative estimates put the dollar value at US$ 7 trillion, but others believe they can support calculations that estimate offshore wealth at US$25 to US$30 trillion. Suffice it to say it is a lot of money and it is held not without consequence.

How Much Tax Are We Talking About Here?

Again, given that secrecy is a tenet of offshore avoidance, no one knows for certain how much tax is avoided globally. The current estimate is that governments around the world lose US$700 billion annually: US$200 billion of that comes from personal tax avoidance and the remaining US$500 billion comes through corporate avoidance.[2] About 75% of the Fortune 500 companies use offshore tax accounts as part of their business model.

In Canada, estimates pin losses at 10 to 15 billion Canadian dollar (CAD) yearly, with two-thirds of that being lost on the corporate tax revenue side.[3] To put this in context, this number is approaching 10% of the revenue that the government brings in yearly through taxation. Those who advocate for social justice through taxation fume over losses of this magnitude when social programs continue to struggle for funding in the first world. Furthermore, the countries that provide the platforms for these financial shells and structures are consistently underfunded with respect to social program spending for their own citizens.

Are All These Companies and Well-Healed Clients Breaking the Law?

Tax avoidance is legal. Tax evasion is not. Despite the fact that those listed in the Panama and Paradise Papers get their names dragged through the mud in the media for the most part these individuals and corporations are just demonstrating smart fiscal prudence. Some have suggested that albeit not illegal tax avoidance is morally questionable. This is a point for much debate.

While the bulk of these activities are legal, there are certain aspects of offshore havens that are appealing to those running less than legal enterprises. Secrecy and less regulation are great if you're looking to launder profits from illegal activity. In reality, the majority of illegal activity with offshore accounts is not all that exciting. The bulk of criminal endeavour lies in hiding revenue from the country where you are a citizen. Holding offshore accounts is legal. Making profits and failing to report it as income back home may not be.

For the wealthy one of the more appealing offshore vehicles is an investment trust with designated beneficiaries. An individual puts legally earned wealth offshore and benefits from investing with favourable or no capital gains taxes. Designated beneficiaries of the trust—like children and extended family members—can be legally paid disbursements from the trust which are legally taxed as income back home. Depending on the jurisdiction, the individual who established the trust choses he or she can avoid inheritance tax upon their passing. One could imagine how in the case of vast family fortunes the hurdles involved might be worth the savings gleaned.

What Exactly Is the Canadian Revenue Agency (CRA) Doing About the Problem?

The Canadian government is actively trying to repatriate lost income from known tax havens by increasing funding to track down lost revenue. In fact CRA claims they have recovered 25 billion CAD in the past 2 years, but some have argued that by signing agreements with known tax havens with an aim to increase transparency and track down offenders, they have actually opened up options for those looking to head offshore. It hasn't

helped however that several prominent former government officials and those with ties to the governing party have been implicated in taking money and tax revenue offshore.

The reality is that when we use the simplest definition of a tax haven, many countries fit the bill. Canada is a tax haven for American corporations as a result of a lower smaller business taxation rate and our government does this on purpose to attract income and wealth. The United States is a tax haven for Canadians with respect to personal income and the list goes on. Governments actively use favorable taxation to compete for business while decrying those who take business away with the same approach. Without a united assault against discrepancy, it seems hard to imagine a world where tax havens will not exist.

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