t. LXXIV • nr 11/2021 (881) • DOI 10.33226/0137-5490.2021.11.1

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International tax competition versus optimisation strategies adopted by holding companies in tax havens

Międzynarodowa konkurencja podatkowa a strategie optymalizacyjne holdingów wykorzystywane w rajach podatkowych

Abstract

The subject-matter of the article is presentation of the phenomenon of international tax competition which is related to the developing tax policies of countries. It is particularly important to distinguish the phenomenon under discussion from harmful tax competition. In the course of elaboration, it is necessary to mention tax havens that exert a substantial influence both on international and harmful tax competition. Holding companies also influence international tax competition as they adopt numerous tax engineering instruments within the framework of their tax strategies. The present article indicates the most important as well as the most up-to-date ones. The elaboration also presents how the relations and links that are being shaped between countries that are tax havens (though not only) and international holding companies impact international tax competition.

Keywords: tax competition, tax optimisation, tax havens, holding

JEL: K22, K33, K34

Streszczenie

Przedmiotem artykułu jest przedstawienie zjawiska międzynarodowej konkurencji podatkowej, które wiąże się z kształtującymi się politykami podatkowymi państw. Szczególnie istotne jest odróżnienie omawianego zjawiska od szkodliwej konkurencji podatkowej. W ramach opracowania odniesiono się do rajów podatkowych, które mają istotny wpływ zarówno na międzynarodową, jak i na szkodliwą konkurencję podatkową. Na międzynarodową konkurencję podatkową wpływają również holdingi międzynarodowe, które w ramach swoich strategii podatkowych wykorzystują liczne instrumenty z zakresu inżynierii podatkowej. Niniejszy artykuł wskazuje najistotniejsze, ale i najbardziej aktualne z nich. Opracowanie przedstawia również, jak na międzynarodową konkurencję podatkową oddziałują kształtujące się relacje i powiązania zachodzące pomiędzy państwami będącymi rajami podatkowymi (ale nie tylko) a holdingami międzynarodowymi.

Słowa kluczowe: konkurencja podatkowa, optymalizacja podatkowa, raje podatkowe, holding

Introduction

The phenomenon of international tax competition is of key importance in shaping holding companies' tax-optimisation policies. Accordingly, competition is worth analysing not only from the perspective of holding companies but also from the perspective of states where holding structures conduct their activity. One must remember that this phenomenon results from the fact that states compete with each other to attract financial capital to their territories.

The notion of an international tax competition is strictly related to tax havens and the basic rules of international tax law (especially the residence rules and the source principle, which are the fundamental rules of tax law).

The tax haven phenomenon has long been an economic reality. However, it assumed extraordinary significance when the world economy began to turn global. Tax havens have thus become an interesting solution for international holding companies seeking to optimize their tax policies.

The mechanisms of formation and functioning of tax havens are inextricably related to the phenomenon of international tax competition which is gaining increasing importance. It is nearly impossible to explicitly define a tax haven without referring to the phenomenon of international tax competition. This is because tax havens are primarily associated with states or territories engaged in tax competition, i.e., states that offer tax privileges to attract foreign capital. The existence of tax havens results from the classic division of tax jurisdictions into countries that export capital and countries that import it (Głuchowski, 1996, p. 19). If such an approach is assumed, each state that is an importer of capital, and thus a source state, might be a potential tax haven. It appears necessary to describe what tax competition actually is by naming its most undesirable forms. Tax competition occurs in tax systems that provide for zero tax rates or in tax systems that are drastically different from other states' systems.

International tax competition

Tax havens are an international phenomenon that results from the existence of differences among national tax statutes. An international dimension of this phenomenon requires reference to the problem of taxing the incomes of international holding companies, the issue of movement of capital between states and the resulting tax-related consequences. Thus the existence of tax havens as an international phenomenon is rooted in global process and indeed, is not exclusively a manifestation of tax sovereignty.

Deliberations devoted to the issue of international tax competition are aimed at identifying the reasons for the emergence and operation of tax havens both from the perspective of relationships among particular tax jurisdictions and from the perspective of international holding companies. It is recognized that tax systems interact with one another on an international level, and this fact is not meaningless for holding structures' tax situations.

The phenomenon of international tax competition is concerned with implementing legal rules that reduce the tax burdens of a given state's statutory law to attract foreign capital (i.e., a holding company). A reduction in tax liabilities may not be regarded as an outright limitation of tax revenue simply because it applies to income that could not have been taxed if such tax benefits had not been introduced (Endres, Schreiber, Dofmuller, 2006, p. 48). Therefore, it is not true that the only justification that accounts for tax competition consists of the non-tax benefits arising out of an inflow of foreign capital. However, one inevitably must inevitable consider whether engaging in international tax competition also involves the unintentional creation of tax benefits. It is not possible to predict all of the consequences that might arise in connection with undertaking a fiscal system reform and it is even less possible to predict the influence of such a tax reform on tax systems in other countries. It seems, however, that tax competition should be associated with both intended and unintended forms of creating tax benefits to attract the capital of international holding companies. The presented distinction is only theoretical because the consequences of tax competition remain the same regardless of their form.

The issue of international tax competition has two main aspects: first, it is perceived that some countries attempt to make the accumulation of savings in their territories more attractive by not imposing tax on interest paid to non--residents; and second, some countries attempt to attract foreign capital, especially the more mobile forms of investment, by imposing lower tax rates or offering other tax benefits. The first aspect is concerned with portfolio investments made especially by natural persons and it is often employed for the purpose of tax evasion. Conversely, the second aspect is related to direct investments made by international holding companies and chiefly allows for tax avoidance. In effect, these two aspects combine to form a source of fiscal deterioration in states that impose high or moderately high taxes.

Direct satisfaction of the demand for equal tax treatment in the international tax law system is impossible because of the lack of effective mechanisms that might limit countries' tax sovereignty. Attempts to reach agreement in this respect are only incidental or particular in character. It is necessary to pay attention to the issues of tax harmonization and coordination because these processes have followed the economic integration of highly developed countries (Gajewski, 2017, p. 112). Existing tax systems may not ignore the international dimension of taxation. Double-tax--avoidance agreements, legal measures to counter international tax opportunism and regulations that govern the allocation of profit generated by international holding companies constitute a response to international tax problems. A challenge presents itself with respect to cooperation that neutralizes the interactions among various tax regimes, although maintaining coordination with respect to income taxes on capital is of vital importance. Such actions consist of eliminating differences that might affect countries' tax-related attractiveness, which influences the location of an investment and the place of business activity. Nevertheless, complete elimination of international tax competition and consequently, satisfaction of the demand for absolute tax neutrality, is not possible because that would require harmonization of all states' tax statutes, which is clearly a utopian vision. Accordingly, it is only possible to alleviate the presented issue and eliminate its most undesirable forms. In effect, tax benefits will always determine investment decisions and the choice of a location for capital will not necessarily be made solely based on productivity and wealth levels.

Tax competition may be partially explained by the need of some poorer countries to earn income, along with the fact that mechanisms allowing for fulfilment of the redistribution function on an international scale are lacking. However, it appears that it is not possible to make a clear distinction between harmful and positive tax competition pursued by means of tax reductions. The conclusive categorization of

certain tax strategies as harmful would require the specification of ethical standards that would apply to relationships among tax jurisdictions, which remains unachievable (Peters, Snellaars, 2001, p. 44). This is not the same as eliminating harmful tax competition, however, because the reasons for and negative consequences of certain actions are known.

As a cause for reduced income and the application of preferential tax mechanisms, international tax competition is an important source of tax avoidance and tax evasion, which result in the erosion of tax bases (fiscal degradation) and consequently, losses in tax revenue. Tax avoidance and evasion in international relations may be understood as means of obtaining foreign capital; they are, therefore, inherent in international tax competition. This claim leads to the further conclusion that both phenomena are not only individual in character — i.e., they shape a particular tax--related situation — but also produce an impact on a larger scale, connected to the tax policy of a given state with respect to the more or less relentless importation of capital (Keen, Konrad, 2012, p. 71). This type of capital importation will always come in minus for other tax jurisdictions that may claim to be entitled to impose tax. International tax competition therefore creates a particular tax environment in a given jurisdiction and shapes that jurisdiction's tax system. The phenomenon under discussion is not only dynamic in the sense that it occurs on a global scale but also static because it constitutes a source of creation and operation for tax havens. It seems, however, that among the factors that lead to the minimization of taxation, a preferential tax system is one of the most important. Under these circumstances, international tax avoidance and tax evasion appear to be secondary elements caused by particular provisions of tax law that apply in states that engage in harmful tax competition (Jacobs et al., 2010, p. 280).

International tax competition may not be offered a conclusive evaluation, which has already been justified with arguments both in favour of and against the issue under discussion. Tax competition always has both positive and negative consequences. The mechanisms governing the presented phenomenon do not arise out of the ill will of a tax jurisdiction that imports capital. The chief factor that intensifies tax competition is foremost, the rapidly growing freedom to conduct business activity connected to transformations in the world economy (Gajewski, 2017, p. 118). In effect, holding companies engaged in cross-border business activity use the free movement of capital to an increasing extent, which causes differences among tax systems to increase in importance. This also means that international tax competition is partially independent from the pursuit of a tax policy and therefore, it constitutes a form of tax differentiation.

Tax havens and holding

The functioning of tax havens is directly related to the phenomenon of international tax competition. State policies of tax havens largely shape the scale of the phenomenon of international tax competition. The nature of instruments employed within the framework of tax policies of tax havens may contribute to a transformation of international tax competition into harmful tax competition. The main beneficiaries of benefits offered by countries (including tax havens) within the framework of international tax competition are international holding companies. It is worth noting that the broad catalogue of solutions optimising taxation, which individual countries have to offer, comprises instruments whose nature and construction are varied. These are chiefly solutions based on international tax law.

The doctrine of international tax law is able to distinguish among four categories of the use of tax havens by holding structures, starting from those which are absolutely legal ones — from the perspective of tax law — to those which are prohibited or even felonious (Orlov, 2005, p. 38).

First, companies may use tax havens without any financial motivation when tax operations that have no effect on domestic taxes are involved.

Second, it is possible to use tax havens in a manner that is advantageous for the taxpayer and simultaneously is entirely consistent with the law. This is connected with the phenomenon of exemption from tax granted to companies for some period for the purpose of making certain investments, e.g., in non-industrialized countries, which very often are tax havens (Kotsogiannis, 2010, p. 7).

Third, tax havens may also be employed in so-called international tax planning, which consists of seeking the tax solutions that are the most beneficial for international holding companies. These actions are based on exploiting legal or administrative loopholes or difficulties in exchanging information, and on the complexities of tax procedures.

The fourth category involves the use of tax havens to commit tax fraud, which is a felony (Devereux et al., 2008, p. 1220). This is an act that enables a holding company to evade tax liability through illegal means, for instance, by failing to declare income. Such acts are referred to as tax evasion.

The techniques for carrying out financial operations in tax havens are abundant and not always known. The most popular method of using tax havens is the practice of establishing a company in a given tax haven where it cumulates incomes that are transferred from entities from the same group that are related by capital, that have organizational links and that conduct business activity in states with high tax rates. This practice is known as profit parking.

It is possible to distinguish among three basic methods by which international holding structures use tax havens:

1) treaty shopping;

2) profit transfers through setting prices for the purchase and sale of goods and services, along with maintenance costs, either too low or too high; and

3) using a rotary company (Kempf, Rota, 2010, p. 277).

The phenomenon of treaty shopping is a specific method by which international holding companies use tax havens. Treaty shopping is connected to AADT's. The phenomenon

of treaty shopping is concerned with particular financial actions (i.e., financial operations) outside the borders of a taxpayer's state that consist of applying the provisions of a control AADT and consequently, gaining advantage in the form of a reduction in foreign tax (Gajewski, 2021, p. 11).

International tax law doctrine provides several slightly differing definitions of this phenomenon; however, the nature of treaty shopping involves an entity to achieve its aim. To recap, one might state that treaty shopping is the practice of using an AADT by making transactions or establishing entities in other states exclusively for the purpose of using the AADT's provisions that apply to relationships between an involved country and the third country (Baumgartner, 2017, p. 78). The agreement in question could not be applied in any other case because the entity making use of the preferential conditions is not a resident of a state that is a party (Gajewski, 2021, p. 12).

The mechanism of profit transfers by setting prices for the purchase or sale of goods or services too low or too high consists of the artificial manipulation of those prices by holding structures. Maintenance costs may be similarly manipulated by being fictitiously set too high or too low. In other words, the costs of trade in goods or services and maintenance costs may vary according to an entity often associated with the other party to a transaction. The degree of the association of entities operating in tax havens depends on their form.

The diversity of entities that use tax havens facilitates mutual relations and purposeful interdependence. The existence of this type of phenomenon allows holding structures to locate their incomes in counties where it is most beneficial from a tax perspective based on an analysis of internal and external offer prices.

A profit transfer may be achieved if a holding company located in a state marked by highly progressive taxes sells goods or services to a subsidiary situated in a tax haven at a price that is lower than the actual value. In turn, subsidiaries resell the goods or services at higher prices. Profits are then accumulated in the tax haven.

Flexibility in the method of transferring profit enables a company to influence the amounts and dates of payment. A payment may be set earlier or later depending on the taxation date in a particular country.

An important method of using tax havens by international holding companies involves a rotary company. International holding companies' use of rotary companies is one form of international tax optimization. A rotary company is a legal entity that is situated and subject to tax in a state with low rates, most often a tax haven. Usually, such a company is established and controlled by an entity that remains in a state with high taxes. A rotary company has the following characteristics:

- The founder of a rotary company that is a legal entity (a capital company) possess all or most of the shares in the company and therefore has full control.
- A rotary company should be situated in a tax haven and established in line with local statutory regulations. Its tax independence must be complete, which means that any possible taxes or other burdens may be settled only in a tax haven. Such a company is usually a capital company and is subject to minimal formal requirements.
- The source of income and its intended objectives are of extreme importance. A company's income may be generated in the state of residence of the entity that initiated its formation, or in the state of the main shareholder, or in a third country.
- In certain cases, a rotary company should be a foreign company that does not conduct any business activity in a tax haven and that earns income outside the haven, because only then may it use the offered tax benefits.

The most important purpose of a rotary company is to reduce the amount of profit subject to taxation. The method consists of transferring outside income to a rotary company in a tax haven. This type of procedure is widely used when performing services in kind and trading in rights to intangible goods. This is because tax authorities often cannot identify such operations due to the difficulty of verifying whether they have actually taken place. Companies of this type are also used in sales contracts (Peralta, van Ypersele, 2006, p. 713).

In the cases enumerated above, the achieved benefit will be equal to the difference between the tax rate in a state where a rotary company is situated and the tax rate that would have been applied in a country where income is generated.

One of the areas in which rotary companies are used most often is that of performing services. A company's activity is concerned with the management of rights, such as using or disposing of patents, licenses, know-how, copyrights, or trademarks. It also encompasses all consulting companies.

To avoid both taxation and conflict with tax authorities, companies cannot conduct business activities that are completely fictitious. This is because it is possible to verify whether services are remunerated fictitiously and income is unjustified. Therefore, such companies must prove that they are engaged in an actual business activity and do not merely act as a "mail box" (Pankiv, 2016, p. 469).

A rotary company may also be useful in sales contracts among specific associations. It acts as an intermediary in the purchase of a particular product from the holding company and the resale of that product to subsidiaries while retaining some part of the profit in the tax haven where it is located. In most cases, the only thing that passes through the tax haven are the sales invoices, which are the only proof of a rotary company's "business activity." A tendency to authenticate a rotary company's activity by delegating a minimum scope of activity to it is often observed among companies that use the form of tax avoidance presented above (Sørensen, 2004, p. 1202). International holding companies often use rotary companies for activity that is strictly financial.

Sometimes the most certain measure for transferring funds to a selected tax haven is to forward them though rotary companies situated in other tax havens, e.g., from Portugal to Luxembourg through a rotary company in Lichtenstein. An entity that uses intermediary tax havens considers the quality of bank secrecy in particular tax havens. The greater the number of links, the more difficult it is to identify the real participants in such transactions (Sørensen, 2007, p. 199).

There are three distinguishable forms of rotary company. They include a holding company (which is of particular importance in optimizing international holding companies' tax policy and thus will be more thoroughly analysed in § 6), a financial company, and a licensing company.

There are numerous ways to exploit tax havens. However, the techniques adopted by international holding companies are unique. It is not possible to enumerate all of the techniques that holding structures employ because many of them are based on AADTs and the statutory law of each state. Thus, it seems that creating new tax-optimization techniques for international holding companies depends on the creativity of the interested parties.

A holding company plays a major role in optimizing the taxation of holding structures, which is achieved through tax havens. The effectiveness of this instrument is largely dependent on successfully manoeuvring holding structures through European tax jurisdictions (Ihori, Yang, 2009, p. 215). Holding companies are used not only in tax havens but also in other European states. Therefore, each holding structure should approach the use of a holding company individually.

Conclusions

Tax havens are defined as countries that offer tax privileges to attract foreign capital. The use of such privileges is tantamount to engaging in harmful tax competition by alleviating tax burdens, which is different from tax-related actions taken by highly developed countries. The most important point is that particularly advantageous tax regulations are intended to encourage non-residents to avoid taxation in their own states. Consequently, the phenomenon of tax avoidance assumes an international character, and in one way or another, tax havens "participate" in such actions.

It must be stated that the tax haven phenomenon is inextricably related to international tax avoidance because it a form of active resistance to taxation.

The problems of tax havens, international tax competition and tax avoidance in international relations are a consequence of the (broadly construed) process of globalization. Economic transformations are of key importance, but the standardization of culture and the resulting behaviours of holding companies are also significant.

Technological progress, changes in the manner of conducting business, and other factors have made international financial operations uncomplicated and relatively inexpensive. Accordingly, the number of entities interested in the possibility of accumulating tax savings has increased. Tax avoidance has become a global and progressive phenomenon primarily because of the existence of tax havens (Zodrow, 2010, p. 877).

Tax havens (in context — international tax competition) evolve based on changes in the "global environment" in which they operate. Notably, contemporary tax havens are no longer merely places where one may escape from tax but instead are specialized financial centres whose most significant element (which is important for foreign taxpayers) is its very low tax rates (Tell, 2017, p. 760).

It is noteworthy that some EU Member States are placed in an ambiguous situation. On the one hand, these states lose tax revenue as a result of introducing the practices of traditional tax havens and other jurisdictions marked by preferential tax systems. On the other hand, some Member States are overseas financial centres themselves because they often operate according to tax haven principles in offering tax benefits to non-residents.

It is also important to distinguish between tax havens and tax jurisdictions that have not been classified as tax havens but that use so-called harmful tax preferences. Therefore, it is a priority to establish precise criteria to categorize countries either as tax havens or as harmful preferential tax regimes. If their characteristics are specified, accurate classification will be possible.

It seems that it is possible to consider the notion of a tax haven with reference to other tax-law problems, which in the field of international relations are directly related to tax avoidance. It must be clearly stated that there is a relationship between the notion of a tax haven and international tax avoidance, which is connected with behaviour leading to a legal reduction in tax burden. Both of these phenomena are inseparably related and thus it is impossible to disregard one of them either from a theoretical or a practical perspective.

One must remember that tax havens are equated with the phenomenon of tax degradation that results from harmful tax competition. Global harmonization of tax systems is possible only by arriving at a consensus among all tax jurisdictions. It means that it is necessary to either achieve a consensual agreement or at least to understand the perspectives of countries whose tax policies are perceived as harmful on an international scale. Accordingly, I believe that the process of preventing harmful tax practices should constitute an element of the standardization of the rules of international tax law.

It is very difficult to clearly define the phenomenon of tax avoidance, especially on an international scale, because cross-border holding companies operate on the basis of at least a few jurisdictions. It is even more difficult to draw a border between illegal and legal tax avoidance, which is also related to the existence of a variety of systems of statutory tax law in EU Member States (i.e., the differences among them).

I believe that international tax competition, which is a phenomenon with a direct influence on holding companies' tax policies, will escalate together with the economic crisis. The heightened activity of countries with respect to tax regulations aimed at attracting foreign holding companies' capital is increasingly visible as a part of tax competition.

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