Iwona Przychocka PhD, prof. WSZiP

University of Management and Law
(Chodkowska University) in Warsaw

Methods of making use of tax havens

Introduction

The process of globalisation of the economy and technological development give some taxpayers enormous possibilities of reducing their tax burdens. A barrier keeping them from deciding to avoid taxation is obviously the ethical principles that people follow in their life. However, these are an insufficient form of protecting the state's fiscal interests. Apart from actions propagating the payment of tax, it is also necessary to have legal regulations which make it effectively impossible to engage in such behaviour or reduce the risk of tax abuse.

One instrument that makes it very effectively possible to even totally avoid the need to pay tax is making use of residing in territories where the existing legal system does not provide for any taxation or reduces its dimension to a level that is incomparably lower than in any other country of the world. Such territories are commonly known as tax havens.

This article is an attempt to characterise those interesting areas, showing the possibilities that open up to taxpayers wishing to enjoy the benefit of residing in a tax haven.

The aim of this article is to examine the methods of making use of tax havens by taxpayers intending to avoid or evade taxation, in particular in using clauses of double taxation treaties and pricing understandings enabling the risk to be reduced of the tax authorities calling a transaction into question as a result of ascertaining transfer pricing.

1. Concept and types of tax havens

The tax burden is an essential factor which those conducting business operations on a large scale, especially entrepreneurs with an international profile,

take into account when making business decisions. An excessive burden means that they will look for ways of optimising the taxation of their income, among other things by the migration of enterprises or opening of establishments abroad, in countries where the tax system is more friendly. Natural persons proceed in a similar way if they have considerable financial resources or receive considerable incomes, by investing their savings in countries where the tax regime is less stringent. Such places to which capital wanders are colloquially known as "tax havens", "tax oases" or "tax asylums".

The institution of "tax havens", making it possible to avoid or minimise the obligation to pay tax duty to the state machine has accompanied mankind since ancient times. An example is the Greek island of Rhodes, which was regarded as such a tax asylum as early as in the 6th century BC. Later, an example of such enclaves might be the towns affiliated in the Hanseatic League, which had their own legal system, enabling entrepreneurs to conduct business activity as a result of a number of convenient financial arrangements. Later, in the era of the colonisation of America in the 18th century, American colonisers sought to escape from the additional tax burdens imposed by the British authorities by making use of commercial agents from the region of Latin America. The globalisation processes and economic and technological development which the 20th century brought to the world saw a mass flourishing of tax havens. In looking for new sales markets, entrepreneurs started to extend their operations beyond the borders of the countries in which they had operated until then. This facilitated a dynamic development of means of transport and infrastructure serving to move goods and people over great distances on a mass scale. Increasing the exchange of goods between various countries was only the first stage on the road to economic development. A further stage involved moving entire enterprises or production establishments. In making such moves, entrepreneurs started to analyse the tax systems of individual countries in terms of finding the most favourable solutions possible that enabled tax burdens to be minimised. These processes were noticed by some countries and territories, which, by introducing very liberal legal solutions, tried to attract foreign entrepreneurs in this way. It quickly transpired that low taxation was not sufficient encouragement. Also of increasing significance was having a developed banking system and maintaining strict bank secrecy. An example can be Switzerland, which was perceived as a tax haven as a result of its financial institutions and banks regarding it as a priority to keep their customers' data secret.

In attempting to specify and explain the term "tax haven" more closely, a starting point can be the definition in an encyclopaedia. A "tax haven" is an area in which, *by virtue of applicable regulations, taxes do not exist, or they exist but have only an internal character and do not encumber the incomes of foreigners and their companies, or encumber them to a minimal degree, as well as an area where special fiscal privileges are granted which specific taxpayers make use of*

or which concern a given type of activity (Tax Haven Encyclopaedia, 1993). The definition cited places the condition of ensuring a preferential tax system in the foreground. However, meeting this requirement is not a sufficient factor enabling a given area to be classed as a tax haven. This is confirmed by the work of the Organisation for Economic Cooperation and Development (OECD), which created a catalogue of criteria qualifying a given area as a "tax haven":

1. Lack of taxation or very low level of taxation;
2. Privileged treatment, in tax terms, of income transferred to such an area in relation to income obtained from sources located there;
3. Lack of clarity of tax provisions guaranteeing particular tax privileges to some entities;
4. Unwillingness to participate in exchanging tax information with the tax administrations of other countries;
5. No obligation for an entrepreneur to conduct activity on the territory of the area (Najlepszy, 2000).

The Organisation for Economic Cooperation and Development also created the definition of a "tax haven", which is one of the most generally accepted definitions due to the OECD's authority. The OECD understands the concept of a "tax haven" to be "*an area in which a legal system exists which enables foreign entities to reduce the tax burdens in their home countries"* (ibid.).

The Polish legal system lacks both a concept and a definition of a tax haven, though it knows the phrase "countries and territories applying harmful tax competition" (Ruling of the Minister of Finance of 16 May 2005 on specifying the countries and territories applying harmful tax competition for personal income tax purposes, Journal of Laws No. 94, item 790, and the Ruling of the Minister of Finance of 16 May 2005 on specifying the countries and territories applying harmful tax competition for corporate income tax purposes, Journal of Laws No. 94, item 791). According to the Ministry of Finance's unofficial definition, a tax haven is a country or territory characterised by the lack of or particularly low taxation (ibid.).

Following the OECD's guidelines, a tax haven on the basis of this study will be a specific area on which a tax system has been deliberately established by differentiating the situation of residents and non-residents, in spite of the standards in force in OECD member countries, and which presents and disseminates information on the possibility of reducing tax burdens as a result of transferring incomes, capital or assets there.

In analysing the features of an area specified as a "tax haven", apart from a non-stringent tax system, one should also distinguish the lack of an efficient exchange of information effectively guaranteeing anonymity or making identification difficult, a highly developed banking system guaranteeing that bank secrets will be kept, political and economic stability, the predictability and sureness of

applicable law, which makes it easier to make business decisions, a developed infrastructure, particularly with regard to IT and telecommunications, making it easier to send and gain information, a low level of bureaucracy and administrative obligations that more than once make it possible not to have to actually reside physically on the territory of the tax haven, and a suitable level of qualified personnel (e.g. lawyers, advisors, accountants, computer specialists and translators). Because of the great progress in transport, the geographical location of the area is a secondary matter, but even so the majority of areas regarded as tax havens are found in warm, attractive tourist places with a favourable climate.

The lack of an efficient exchange of information is a particularly important element making it difficult or even impossible for tax authorities to act against using tax havens in order to reduce tax obligations. It follows from this that the number of agreements enabling tax information to be exchanged with administrations of countries regarded as tax havens is small compared with countries not regarded as tax havens. The existing legal regulations enabling information to be exchanged in principle restrict such exchange to criminal matters.

Difficulties in the exchange of information often also involve the impossibility of identifying the owners of economic entities or shareholders, which is necessary for tax purposes, commercial law or regulations preventing money-laundering.

Tax havens are to a certain extent a contrast to other countries, where tax performances constitute the budget's main income. This is because they are primarily concerned with ensuring security of the funds accumulated and assets invested, and liberal provisions and the anonymity of transactions and the persons participating in them are intended to serve this purpose. For that reason, considering exclusively the **amount of fiscal burdens**, tax havens can be divided into:

1) no-tax havens – countries which have totally given up collecting income taxes, making their main source of budget income the charges paid by natural persons and legal entities. This category can include, for example, Anguilla, the Cayman Islands, the Bahamas.
2) low-tax havens – where tax burdens are definitely lower than in other countries. These countries, by making use of the principle of territoriality, subject to taxation the income coming from sources on their area, while income coming and transferred there from abroad is exempt from taxation. An example of such a tax haven is the Principality of Andorra.
   Within this group we must separate havens giving taxpayers the status of an entity excluded from taxation if they have their registered office in the haven while conducting operations outside it.
3) special tax havens – on whose area there are rather high fiscal obligations, but as a result of very attractive preferences for strictly specified groups of taxpayers or types of business activity conducted they constitute a category half-way between no-tax havens and low-tax havens. An example of these can be the Republic of Liberia.

A different distinction between tax havens on account of **preferences offered** makes it possible to distinguish general and specialist havens (Głuchowski 2006). General havens offer the broadest scope of both tax and financial conveniences. These countries guarantee investors a number of preferences of a fiscal, economic, legal, administrative and financial character. Some of these countries even have special legal regulations having the character of a charter of state obligations (Kuchciak 2012).

Specialist tax havens do not offer such comprehensive solutions. Preferences can only concern a specific type of income or type of activity, or are addressed to particular entities. Specialist havens can also introduce the principle of tax inequality. An example can be the legal and financial solutions in the United Arab Emirates (UAE). The provisions applicable there impose considerably higher tax obligations on companies from the energy and fuel sector than from other sectors (Mazur (ed.), 2012).

Another criterion for a division can be the **tax residence status**. Tax havens can be divided into those enabling taxpayers to obtain exempt status or non-resident status (Lipowski, 2004). Granting the taxpayer the appropriate status depends on many factors such as citizenship, the citizenship of shareholders or managing persons, the place of origin of the capital, the place of acquiring the capital, and the place of the parent company's registered office. As a result of the appropriate status, it is possible to make use of preferences applicable on the territory of the haven which are addressed to a specific group of entities that are entitled to these preferential terms.

A criterion for dividing tax havens can also be their geographical location. The proximity of a tax haven was a decisive criterion of choice in the past. Currently, due to the enormous progress in the field of transport, this factor has lost some of its significance, which does not mean that it is not taken into consideration at all by entities wanting to make use of the preferences being offered by tax havens. The geographical location also to a certain extent determines the type of entities which make use of a tax haven's services. The Principality of Andorra, situated on the border between France and Spain, will undoubtedly be more likely to find itself in the sphere of interests of entrepreneurs from those countries than, for example, the distant Marshall Islands. The largest amount of capital comes from those countries situated nearby. Neither are historical and cultural ties without importance, a good example of which can be the Netherlands Antilles which, while remaining under Dutch rule for a long time, attracted a considerable amount of Dutch capital.

If we use the geographical criterion, we can differentiate countries and territories which do not have access to the sea (e.g. the Principality of Andorra, the Principality of Liechtenstein), coastal countries and territories (e.g. the Republic of Liberia, the Republic of Panama), and island countries and territories (e.g. Anguilla, the Commonwealth of the Bahamas, Bermuda, the Republic of Seychelles).

2. The concept and operation of offshore companies

In tax havens, entrepreneurs conduct their operations using a variety of legal forms which are specified as offshore companies. The word "offshore" can mean "close to the coast" or, depending on the context, "far from land, far from the coast". In financial language, this word has become a synonym for excluding operations from the limits of the home country's tax jurisdiction. It means an entrepreneur registered and operating in a foreign legal system (particularly a tax one), which as a result of transferring its operations to that other (foreign) system makes use of the administrative and financial conveniences offered by that system. Offshore companies are intended above all to carry out financial operations, but the methods and manners of making use of them depend on the type of operations conducted by the entity controlling (founder of) the companies. Services operations generally provide greater possibilities of using offshore companies than do production or trading operations.

Establishing a company in a tax haven is not complicated, because the administrations of those countries impose a minimum of obligations on investors and sometimes presenting the articles of association (statute) or other founding act of the company to the appropriate authorities and paying the fees connected with establishing the entity are the founder's sole obligations. Diplomatic missions in tax haven countries provide all the necessary information, as do specialist law firms. Entrepreneurs transferring their operations to a tax haven usually make use of the assistance of specialist legal advisors, who enable a tax haven to be chosen that is adapted to the client's expectations and who ensure a comprehensive service to the entrepreneur on the territory of a given haven. As a result, the taxpayer is guaranteed maximum financial preferences while at the same time compliance of the actions taken with the tax haven country's legal and administrative requirements, and above all, with domestic tax rules and international regulations.

A variety of legal forms operate in tax havens that are used to conduct economic operations, which differ from one another on account of the differences in internal regulations of particular tax havens. However, several of the most characteristic and popular forms of activity of taxpayers using the preferences offered by tax havens can be distinguished. Among the most typical are: holding companies, trusts, (financial) investment companies and licence companies (Kuchciak, 2012).

The purpose of a holding company is to manage shares or ownership interests of other entities. It usually operates as a capital company within a group and is the managing entity, authorised to receive a dividend on subsidiaries forming part of the group. As a result of making use of this legal form, a distribution of incomes to the entity located in the tax haven ensues. The rule is that dividends paid by the subsidiary will be exempt from taxation in the source country, unless the entity in whose favour the dividend is paid makes use of exemption from

taxation. Due to the fact that a holding company operating in a classical tax haven is not subject to taxation, taxpayers introduce intermediating entities that participate in the transfer of the dividend, in order to release the dividend paid from the tax obligation or reduce it. The important advantages of the operation of a holding company also include the possibility of controlling entities whose shares or ownership interests the company owns, which makes it possible to manage the funds of connected and controlled units. It is then possible to distribute income to the holding company without formally paying a dividend.

Another legal form encountered and used just as frequently is a trust, which is basically not a special kind of company but a contract (understanding, agreement) between the founder, the settlor, the trustee and the beneficiary. The founder transfers assets, which can be real estate; property, plant and equipment, e.g. machines, cars, funds, shares; and also intangible assets such as intellectual property rights. Generally, the transfer of assets (property) has an irrevocable character, and any cessation of a trust can be regulated, for example, by the time period for which an agreement is concluded. The effect of transferring assets to a trust is the transfer of ownership of the assets brought into the trust to the trustee, i.e. the managing person. The trustee becomes the official manager of the property coming from the founder and, although he is formally independent of the founder, in practice he always carries out the founder's instructions. A safeguard is most frequently an agreement between the founder and the trustee, which enables the former to retain full control of the trustee's operations. Although the management of property rests with the trustee, the beneficiary receives the real right to the property. There is nothing to prevent the beneficiary himself from being established as the founder of the trust. The proper construction of a trust ensures total protection of the property brought into the trust against enforcement, expropriation, taxation or claims of potential heirs. That, apart from confidentiality of operations and anonymity, is the enormous advantage of a trust.

Although a trust requires great trust on the part of the parties, the scope of its application is very broad, giving great flexibility in operating and using the goods brought into the trust. It is essential that the trustee should be fully autonomous from the founder, because otherwise the founder will continue to be regarded as the owner of the goods, which will make it impossible to carry out the purposes for which the trust was established.

In the majority of tax systems a trust is regarded as a separate taxpayer, but taxation only occurs from the moment the beneficiary receives the assets. A characteristic feature of a trust is also the fact that it cannot be concerned with conducting business activity, and its existence is limited to managing the assets brought in by the founder. The maximum period for which a trust can be formed is 99 years (Winter, 2010).

A hybrid company is used above all to carry out commercial transactions and combines the features of a trust or private partnership and an incorporated

entity. In a hybrid company, one can see a clear distinction into the shareholders of the company, whose job is to manage the company, and guarantee members, who have the right to a dividend and factually control the company, remaining anonymous to third parties.

The purpose of an investment company's existence is the accumulation of profits coming from various kinds of investments, particularly from loans and guarantees, and then reinvesting them in various kinds of undertakings. An investment company can, for example, participate in a change in direction of the repayment of interest on credit drawn within the framework of a group for subsidiaries, which, as a result of introducing that company to transactions, reaches a tax haven.

A variation on an investment company is a licence company, whose purpose is to accumulate profits coming from property rights to intellectual property. As a result of bringing in or transferring licence rights or other kinds of rights to intellectual property to a licence company, the income from licence dues goes to a company located in a tax haven. As a result, it is possible to avoid or reduce the tax burden on income from licence dues.

In the last two cases, establishing the companies is preceded by an analysis of the double taxation treaties, because their provisions can serve to reduce the tax burden.

3. Making use of double taxation treaties

Each country tries to get the maximum amount of income from taxes, while at the same time maintaining the best possible conditions for undertaking and conducting business operations. In connection with this, the rule is to tax one's own tax residents on all the revenue/income obtained, irrespective of the source from which it comes. This is the **unrestricted tax obligation rule**. The general application of this rule by various countries has the effect that tax residents of those countries, who achieve revenue/income in the same period on the territory of those countries, may be taxed twice. This phenomenon has a very unfavourable influence on economic development, because it leads to double taxation of the same entity for the same period and the same business. International double taxation can be defined as "the imposition by two sovereign tax jurisdictions of the same kind of taxes on the same tax entity, which are due for the same tax period on account of a materially identical subject of taxation" (Gomułowicz, Małecki, 2004). Serving to prevent this phenomenon, which is negative for the development of the economy, are bilateral or multilateral international agreements concluded between countries, the aim of which is to divide the revenue/income among the countries which are parties to the agreement. These agreements are specified as double taxation treaties. According to the list of double taxation treaties published on the website of the Ministry of Finance (as at 1 March 2013), Poland has signed agreements with 89 countries (http://www.finanse.mf.gov.pl, 10 June 2013). Under Article 91 par. 2 of the Polish

Constitution, the regulations contained in individual agreements (ratified with the prior consent expressed in the law) are applied against provisions of internal law and are applied with respect to taxpayers having their registered office or domicile in one or both countries. Thus, in the legal sources system, international agreements, ratified with the consent of parliament expressed in the form of an act, take priority over regulations of acts in the event of a collision between their provisions and statutory regulations. This is reflected in the tax acts regulating income tax taxation, in Article 22a of the Corporate Income Tax Act of 15 February 1992 (Journal of Laws of 2011 No. 74, item 397 as amended) – hereinafter the CITA – and Article 27 par. 8–9a of the Personal Income Tax Act of 26 July 1991 (Journal of Laws of 2012 item 361 as amended) – hereinafter the PITA.

Most of the agreements which have been concluded and are applicable are based on the Model Convention on avoiding double taxation of income and capital of 1963 – hereinafter the Model Convention. It is a model for tax agreements concluded between various countries, including Poland. The Model Convention regulates such matters as the methods of eliminating double taxation, and the choice of those methods and their application depends on the content of a specific international agreement concluded between countries. In practice, the method of exclusion (tax exemption) and deduction (tax credit) dominate (Lipowski, 1999).

The method of exclusion (tax exemption) involves exclusion from taxation by the country of domicile or the registered office of the taxpayer (country of residence) of income obtained in another country (country of source). This method can be found in two variants. **Unlimited exclusion** means that the income obtained in the country of source is subject to exclusion from taxation in the country of residence in its entirety and has no influence on the amount of the rate of tax on income subject to taxation in the country of residence. The second variant is **exclusion with progression**, in which the income coming from the country of source is subject to exclusion from the taxation basis in the country of residence, but before its exclusion all income, irrespective of where it is achieved, is accumulated in order to determine the tax rate.

The method of deduction (tax credit) refers to taxation in the country of residence of the taxpayer's total income (irrespective of where that income has been achieved), and then calculating the tax due on that total income and deducting from it the amount of tax paid in the country of source. The amount of deduction must not be higher than the tax paid in the country of source, in which case we are dealing with **full (unlimited) deduction**, which is, however, rarely applied. What is more common is to deduct the tax paid in the country of source only up to the amount of tax due proportionally for the income achieved in the country of source, and this is **deduction with a limit (proportional)**.

Applying the method of exclusion is usually more favourable for the taxpayer because double taxation treaties generally determine the amount of tax at source at a level lower than taxing that income in the country of residence.

Apart from eliminating the phenomenon of double taxation, an important aim of concluding double taxation treaties is to be the prevention of tax fraud and the avoidance of taxation. The procedures of mutual agreement between countries are designed to serve these purposes, as are the provisions regulating cooperation in tracking down tax dues. According to OECD experts, introducing rules to the Model Convention which concern tax assistance (Article 27) was intended to restrict tax abuse on an international scale, and in the future to enable the network of double taxation treaties to be extended to cover territories classed as tax havens. The exchange of information and assistance in the choice of tax were recognised as the only available tax policy resource making it possible to counteract harmful tax competition. In practice, however, double taxation treaties have contributed to the creation of techniques on their basis, which use the provisions of the treaties and the existence of tax havens to lower taxation. These techniques include: taxing passive income achieved, acquiring contractual benefits (treaty shopping) and excluding part of the income from the domestic tax system.

Passive income is characterised by a lack of tax-deductible costs, which means that the revenue is subject to taxation. Examples of passive income are licence dues, interest and dividends (Kuchciak, 2012).

In Polish rules regulating taxation with income tax, there is no definition of "licence dues". However, in Article 21 par. 1 pt. 1 CITA and Article 29 par. 1 pt. 1 PITA, the legislator mentions rights which fall within the scope of the concept of licence dues. According to Article 12 par. 2 of the Model Convention, the term "licence dues" means all kinds of dues paid for using, or for the right to use, all copyrights to a literary, artistic or scientific work, including films for cinemas, all patents, trade marks, designs or models, plans, technological secrets or production processes, or for using professional experience in industry, commerce or science. Tax havens are used to lower taxation on account of licence dues, thanks to offshore companies, which act as a licensor. Appropriate regulations of the double taxation treaty between the country of the registered office of an entity receiving a licence due and the country of the registered office of the company making the payment are a prerequisite for lowering taxation. In the event of the lack of an appropriate agreement between the countries in which the licensor and licensee have their registered office, an additional entity is often created from a country having an appropriate agreement with the country of the licensor's registered office.

Interest is remuneration for using foreign money (capital) or dealing with one's own resources in someone else's interests. Article 11 par. 3 of the Model Convention specifies interest as "income from all kinds of claims arising from debts, both secured and not secured with a mortgage or right to participate in the debtor's profits, particularly income from public loans and income from bonds or debentures, including bonuses and awards connected with such debentures, bonds

or loans. Penal charges for delayed payment are not regarded as interest within the meaning of this article" (S. Babiarz, L. Błystak, B. Dauter, A. Gomułowicz, R. Pęk, K. Winiarski, 2011). Using tax havens most often involves an offshore company establishing another company on the territory of another country where the operations will be conducted, and then financing its operations with loans. As a result, it becomes possible to reduce the taxation basis in the country of the registered office of the company receiving a loan by the cost of the interest paid in connection with such loans. This phenomenon is known as thin capitalisation. In some countries (including Poland), there are regulations serving to prevent that phenomenon. Under Article 16 par. 1 pt. 60 CITA, tax-deductible costs are not interest on loans (credit) granted to the company by:

– its shareholder or shareholders,
– holding not less than 25 per cent of the shares of that company,
– if the value of the company's debt towards that shareholder or shareholders or towards other entities holding at least 25 per cent of the shares in the capital of that shareholder reaches a total of three times the value of the company's share capital, in the part in which the loan (credit) exceeds three times the value of the company's share capital, according to the state as on the day of payment of interest.

Neither are tax-deductible costs the interest on loans (credit) granted to the company by another company, if in both those entities the same shareholder holds at least 25 per cent of the shares in each case, and the debt value of the company receiving the loan (credit) towards the shareholders of that company, holding at least 25 per cent of its shares, and towards other entities holding at least 25 per cent of the shares in the capital of those shareholders, and towards the company granting the loan (credit) reaches a total of three times the value of the share capital of the company receiving the loan, in the part in which the loan (credit) exceeds the above value of the debt, specified as on the day of the payment of interest (Article 16 par. 1 pt. 61 CITA). It follows from the above regulations that the Polish provisions intended to prevent the phenomenon of thin capitalisation were based on two conditions, the cumulative fulfilment of which conditions the limiting of the amount of tax-deductible costs in the form of interest on loans. The first condition is that the interest is due to entities classed as significant shareholders, the value of their direct or indirect shares in the capital of the company paying the interest being at least 25 per cent. The second condition is exceeding the value of the company's debt towards significant shareholders by at least three times the value of the company's share capital.

Taxpayers, in order to prevent regulations acting against thin capitalisation, often decide to make use of the services of a recognised financial institution, which instead of the offshore company takes part in financing an entity located in a country which is not a tax haven. Refinancing is then done at a slightly smaller rate than the interest of the loan granted by the financial institution. This

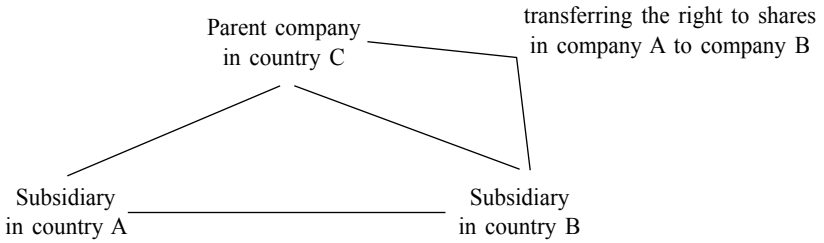
solution ensures the avoidance of capital connections with an entity located in a tax haven.

Financing economic ventures by entities operating in tax havens is much more effective from a tax point of view than those entities deriving income from dividends paid out to them. Because of significant differences between the legislation of particular countries, the Model Convention (in Article 10 devoted to dividends) does not define the concept of a dividend, limiting itself to stating examples contained in the majority of the legislations of OECD member states. On the basis of Polish law, we specify a payment from the profit of a company being a legal entity in favour of its shareholders as being a dividend. The payment of a dividend entails the negative phenomenon of double taxation for business dealings, because it occurs from the legal entity's income remaining after taxation. For that reason, making use of double taxation treaties entails, in the case of dividends, the phenomenon of treaty shopping.

Treaty shopping is "performing specific financial operations outside the taxpayer's country, involving the application of provisions of a specific double taxation treaty, which operations consequently lead to a reduction of foreign tax" (Lipowski, 2004). Acquiring contractual benefits therefore involves making use of the provisions of a double taxation treaty by locating, on the territory of a country which is party to a treaty whose provisions serve to reduce or avoid taxation, an entity whose purpose is precisely meant to be reducing or avoiding taxation. Considering that a very small number of double taxation treaties contain clauses preventing the acquisition of contractual benefits, this procedure can be regarded as being legal. The phenomenon of treaty shopping is usually found with respect to passive income, which is characterised by a lack of tax-deductible costs, meaning that the revenue is subject to taxation. What is characteristic of treaty shopping is the participation in a venture of entities from three different countries, and achieving a tax benefit and the place of its realisation depends on how the double taxation treaties between those countries and the provisions of the tax law of each of those countries is formulated. For that reason we can distinguish between direct and indirect treaty shopping (Kuchciak 2008).

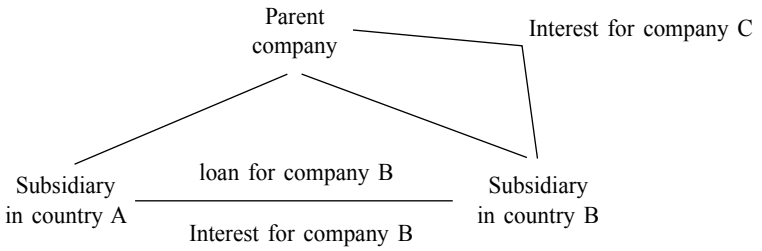
Direct treaty shopping applies when a double taxation treaty applicable between countries A and B provides for exemption from tax in the country of the source of the dividends paid out by the company to shareholders in the other country. But country C, where the parent country has its registered office, does not have such a treaty with either country A or country B. To achieve tax benefits, the parent company establishes subsidiaries in countries A and B, and then transfers the right to a share in the profits of the company from country A to the company with its registered office in country B. As a result, the income from dividends is accumulated in country B. Diagram No. 1 presents an example of direct treaty shopping.

Diagram 1
Acquisition of contractual benefits in a direct manner.



The acquisition of contractual benefits in a direct manner is more complicated and requires steering the costs and revenue of the subsidiary. Apart from the provisions of double taxation treaties, also of great importance is the content of the tax provisions of the country used for transferring income. These regulations are used for concluding such an agreement between the parent company and the subsidiary (e.g. a loan) whose effect is to obtain tax-free interest. Moreover, a condition of the success of the venture is the existence of a double taxation treaty between countries A and B in which the subsidiaries have their registered offices, by virtue of which the interest paid in the country of source to residents of the other country is exempt from tax in the country of source. As in the case of the direct method, there is no treaty eliminating double taxation with the country in which the parent company has its registered office. As a result of using the provisions of the double taxation treaty applicable between countries A and B and favourable regulations in country B, the parent company from country C will receive interest via the subsidiary from country B without the need to pay the taxes applicable in country B.Diagram No. 2 presents an example of indirect treaty shopping.

Diagram 2
Acquisition of contractual benefits in an indirect manner.



The difference between direct and indirect treaty shopping is that the indirect method leads to a reduction of the tax burden in the intermediating country

through expenses balancing each other out mutually, whereas the direct method is based on making use of tax exemption.

Excluding part of the income from taxation is possible as a result of setting up a branch office in another country, known as a permanent establishment in tax law terminology. Under Article 4a pt. 11 CITA (Article 5a pt. 22 PITA), a foreign permanent establishment, unless the double taxation treaty states otherwise, is:

– a permanent outpost through which an entity domiciled on the territory of one country wholly or partially carries out operations on the territory of another country, and particularly a branch office, representative office, office, factory, workshop or place of extraction of natural resources,
– a building site, construction, assembly or installation, run on the territory of one country by an entity domiciled on the territory of another country,
– a person who, on behalf of and for an entity domiciled on the territory of one country, operates on the territory of another country, if he or she has power of attorney to conclude agreements on behalf of his principal and factually performs that power of attorney.

It follows from the definitions cited that it is above all the provisions of a double taxation treaty that determine the existence of a permanent establishment on the territory of another country. Their content is particularly significant for specifying situations which exclude the existence of the entrepreneur's permanent establishment on the territory of another country. Article 5 par. 4 of the standard double taxation treaty concluded by Poland states that a permanent establishment is not a facility used only to store, display or issue goods belonging to an enterprise, to keep supplies merely for storing, displaying, issuing or processing by another enterprise, nor a facility maintained solely to purchase goods, gain information or conduct any other activity of a preparatory or auxiliary character. For a permanent establishment to be set up, it is therefore essential to physically and organisationally separate part of the enterprise outside the country in which the entrepreneur has its registered office, in order to conduct operations on the territory of another country via that separated part.

Under Article 7 of the Model Convention, if an enterprise conducts business operations through a permanent establishment in another country, the profits achieved there can be taxed by virtue of internal regulations of the appropriate countries both in the country of the enterprise's registered office and in the country in which the permanent establishment is located, but only to the extent to which it is possible to ascribe them to that permanent establishment (S. Babiarz, L. Błystak, B. Dauter, A. Gomułowicz, R. Pęk, K. Winiarski, 2011). Using a foreign permanent establishment to exclude part of the income from taxation is possible as a result of appropriate regulations of the double taxation treaty concluded between the country of the enterprise's registered office and the country in which the permanent establishment is located. The provisions of that treaty enable the income and tax-deductible costs to be separated between the enterprise and the

permanent establishment. The Model Convention indicates the acceptance of the fiction of the independence of the permanent establishment and the entrepreneur. The division of the revenue and costs between an enterprise and a permanent establishment takes place on the assumption that the permanent establishment is achieving such revenue and incurring such costs which an entity conducting similar operations would achieve in the same or similar conditions as a separate and independent enterprise, totally independent in its relations with the enterprise whose permanent establishment it is.

The amount of tax benefits achieved by an enterprise from having a permanent establishment depends on the tax rate encumbering the permanent establishment's income and on the share of the income of a foreign permanent establishment in the enterprise's entire income. Taxing the income of a permanent establishment is dependent on the regulations of the country where the permanent establishment is located. If a permanent establishment's income is taxed with a lower rate than the enterprise's income, the enterprise might be interested in transferring the income to its foreign permanent establishment. Additionally, having a permanent establishment abroad can also bring benefits other than tax benefits, e.g. the permanent establishment is under no obligation to transfer foreign currency to the home country, it can have a bank account abroad and it can engage in other activities not covered by foreign currency permits but which are connected with a permanent establishment's operations.

4. The application of transfer pricing

One way of transferring income to a tax haven is the mechanism of transfer pricing. Transfer pricing should be understood to mean "*prices at which an enterprise transfers goods or non-tangible goods and provides services to an affiliated enterprise"* (Kuchciak, 2012). Since the mechanism of transfer pricing is applied between affiliated entities, it is important to be precise about this concept. On the basis of the Polish tax law system, the term "affiliated entity" is found in the Corporate Income Tax Act (Article 11) and the Personal Income Tax Act (Article 25). In accordance with these regulations, if:

- a taxpayer of income tax with its registered office (management board) or domicile on the territory of the Republic of Poland, hereinafter referred to as a "domestic entity", takes part directly or indirectly in managing an enterprise located abroad or in controlling it or has a share in the capital of that enterprise, or
- a natural person or legal entity with its domicile or registered office (management board) abroad, hereinafter referred to as a "foreign entity", takes part directly or indirectly in managing a domestic entity or in controlling it or has a share in the capital of that domestic entity, or

- those same legal entities or natural persons at the same time take part directly or indirectly in managing a domestic entity and a foreign entity or in controlling them or have a share in the capital of those entities

and as a result of such affiliations conditions are established or imposed which differ from the conditions which independent entities would establish among themselves, and as a result of this the entity does not show income or shows income lower than that which should be expected if the affiliations referred to had not existed – the income of a given entity and the due tax are specified without taking into consideration the conditions arising from those affiliations.

It follows unambiguously from the regulations cited that just staying in a capital or personal union is not sanctioned. What is of tax importance is using such affiliations in order to avoid or lower taxation and this carries the danger that the income might be estimated.

The burden of evidence to show affiliations between entities and their influence on the amount of the taxpayer's income rests with the tax authority. The words *takes part directly or indirectly in managing an enterprise* must be understood as a factual influence on shaping business decisions or controlling an affiliated entity (S. Babiarz, L. Błystak, B. Dauter, A. Gomułowicz, R. Pęk, K. Winiarski, 2011). It is necessary to show the factual operations or omissions directly influencing the decisions or behaviour of the taxpayer that take effect in avoiding or lowering taxation. The tax authority is also obliged to examine the value of a transaction and to show that it was carried out on conditions differing from those which independent entities would establish among themselves, as a result of which the taxpayer does not show income or shows income lower than what would be expected. The cited provisions of Article 11 CITA and Article 25 PITA are accompanied by regulations imposing an obligation on taxpayers to prepare particular tax documents of a transaction (Article 9a CITA and Article 25a PITA) and giving the right to tax the estimated income at a corrective rate (Article 19 par. 4 CITA and Article 30d par. 1 PITA).

The lower and upper limits of the transfer pricing are defined by the cost of production or of buying goods or services being the subject of a transaction with an affiliated entity, as well as by the lowest market price which the buyer of the goods or services being the subject of the transaction would have to incur when buying from an independent entity. Affiliated entities can strive to lower the amount of the total tax burdens, for this purpose using internal regulations of the tax systems in which they operate. By manipulating the amount of payment for mutual performances, they can transfer part of the income to the territory of the country in which the tax burdens are lower. Using the mechanism of transfer pricing for this purpose involves selling goods to an entity with its registered office in a tax haven, which then resells those goods to the end buyer at a price higher than the transfer price paid to the seller. As a result of these transactions, the original seller achieves a lower profit, which consequently reduces its tax

obligation. The factual profit on a transaction is achieved by the company located on the territory of a tax haven, which, however, due to favourable tax regulations, does not pay tax at all or pays it to a lower extent.

We can also encounter the mechanism of transfer pricing in the case of services, with the difference that reducing the income at a taxpayer located in a country which is not a tax haven involves increasing the tax-deductible costs. The most frequently purchased services are management services or those involving performances for shareholders, such as audits, providing services at meetings etc., legal, advisory and financial services, and marketing or insurance services. These services are chosen on account of the difficulty involved in their market valuation which reduces the risk of those transactions being called into question by the tax authorities (Najlepszy, 2000). These operations are also attractive in tax terms because the remuneration for such services is usually high which makes it possible to avoid or reduce the taxation on a considerable part of the income.

Connected with the problem of transfer pricing is the institution of a price understanding, the essence of which is to ensure that affiliated entities have stability in planning prices in transactions between them. Price understandings were introduced into the Polish legal system on 1 January 2006 by amending the Tax Law of 29 August 1997 (Journal of Laws of 2012 item 749 as amended) – hereinafter the Tax Law – and constitute an important element of tax planning, which reduces the risk in a situation where the taxpayer complies with the conditions of the understanding concluded.

An understanding is concluded on the taxpayer's initiative and requires negotiation between the taxpayer and at least one tax administration. Under Article 20f of the Tax Law, an entity applying for an understanding to be concluded is obliged to present:

1. a proposal to apply a method of determining the transaction price, and particularly to indicate one of the methods referred to in the CITA or PITA;
2. a description of the manner of applying the proposed method in reference to the transaction which is the subject of the understanding, and particularly to indicate:
   a) the rules of calculating the transaction price,
   b) the financial forecasts on which the calculation of the transaction price is based,
   c) an analysis of the comparative data used to calculate the transaction price;
3. circumstances which could have an influence on correctly determining the transaction price, in particular:
   a) the type, subject and value of the transaction which is to be the subject of the understanding,
   b) a description of the development of the transaction, including an analysis of assets, functions and risks of the transaction parties, as well as a description

of the costs connected with the transaction which are anticipated by the transaction parties and a description of the transaction parties' business strategy and other circumstances, if that strategy or circumstances influence the price of the subject of the transaction,

c) data concerning the business situation in the industry in which the applicant conducts its operations, including data concerning business operations being concluded by unaffiliated entities, which were used to prepare the calculation of the transaction price,

d) the organisational and capital structure of the applicant and entities affiliated with it which are parties to the transaction, and a description of the financial accounting rules applied by affiliated entities;

4. documents having a significant influence on the amount of the transaction price, particularly texts of agreements, understandings and other documents indicating the transaction parties' intentions;
5. proposals of the period for which the understanding is applicable;
6. a list of affiliated entities with which the transaction is to be carried out, together with their consent to submit all documents concerning the transaction and the necessary explanations to the appropriate authority in the matter of the understanding.

In Poland, the Minister of Finance is the appropriate authority in matters concerning the conclusion of a price understanding. In Article 20a and Article 20b of the Tax Law, three kinds of understandings have been provided for:

1. unilateral: where the Minister of Finance is the appropriate authority for approving the correctness of the prices applied;
2. bilateral: which occur after the tax authority appropriate for a foreign affiliated entity has given its consent, and after acknowledging the correctness of the price applied between a domestic entity and a foreign entity affiliated to it; to conclude such an understanding, it is necessary to have the consent of both interested tax authorities;
3. multilateral: concluded if, apart from a Polish taxpayer, also foreign entities from more than one country participate in a transaction being the subject of an application.

The analysis of the documents submitted lasts from 6 to 18 months and is completed by the issuance of a decision which will be applicable for not longer than five years. Achieving a price understanding means that the methods of determining transaction prices and the level of those prices will not be called into question by the Polish tax and fiscal authorities.

Conclusions

The problem of the functioning of tax havens, while being very complicated, if nevertheless focused on perceiving such an area as an oasis against paying taxes, it enables one to concentrate on the essence of the issue by demonstrating the conflict of interests between the taxpayer and the state authorities. This age-old rivalry took on a dynamic form in the 20th century, mainly due to technical and economic development. For this reason, the article concentrates on presenting the techniques applied by taxpayers in order to avoid or evade taxation, and the activities of state authorities aimed at ensuring the appropriate tax proceeds.

From the point of view of the state, the operations of tax havens are a negative and undesirable phenomenon, as they restrict budget proceeds and increase the lack of balance in the distribution of taxable income. This also causes losses as a result of the lack of competitiveness of entities not making use of the services offered by tax havens, turbulence on the financial markets and an increase in the profitability of criminal activities. That is why methods of making use of tax havens that enable benefits to be derived have also been presented. Tax havens, due to barriers restricting the transparency of capital and financial operations being carried out, often serve and are used by persons and organisations not to conduct legal operations but rather to deal in goods or services whose trade is prohibited (e.g. drugs). The income from such operations, even if invested in legal ventures, will always and with the use of all methods defend profits from criminal activity. That is why methods of making use of tax havens that enable benefits to be derived by taxpayers resorting to them have also been presented.

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Summary

Article *Methods of making use of tax havens* concentrates on presenting the techniques applied by taxpayers in order to avoid or evade taxation, and the activities of state authorities aimed at ensuring the appropriate tax proceeds. From the point of view of the state, the operations of tax havens are a negative phenomenon.

Article presents concept and types of tax havens, the concept and operation of offshore companies, making use of double taxation treaties and the application of transfer pricing.

Keywords: tax havens, offshore companies, taxes