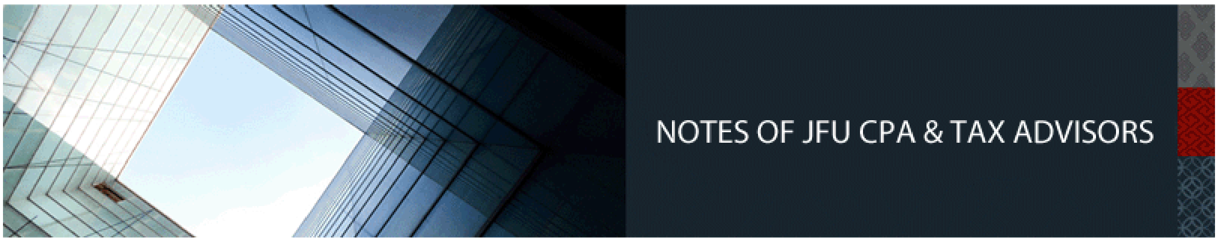

Tax Planning – the Tax Tail Should Not Wag the Business Purpose

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In the months and weeks leading up to the G8 conference in Enniskillen, Northern Ireland and subsequently prior to the G20 summit in St Petersburg, there was much publicity about multi-nationals “squirreling” away millions in offshore havens to avoid home country taxes, not through tax evasion, but by relying on domestic and international tax rules. Some believe this has come about mainly because outdated tax rules cannot keep up with rapid developments in the mode of international business operations.

A heinous act?

Notwithstanding the legitimacy of such form of international operations, both taxpayers and their advisers have been subject to harsh criticism. Many have questioned if tax planning should be considered a "heinous” act in the light of accusations made on grounds of civic and moral duties. Accusations such as “reducing available resources .. to build schools, hospitals and infrastructure” and "diverting funds which could be otherwise used to alleviate poverty", do touch the heart of people with a strong sense of social injustice.

Let's step back and take a broader look at the relationship between tax planning and tax policy. As with other public policies, tax policies are rarely neutral (not causing distortion of behavior) but are directed to impose constraints or provide incentives through markets or regulations. Even if a particular tax rule is intended to be neutral, those affected would still respond to it in some way because of the very nature of taxation, particularly its redistributive effects and associated public sentiments. Thus in dealing with business affairs and personal wealth, no one who take such matters seriously would ignore taxation. Hence tax planning thrives.

Tax planning is far from being an undesirable evil, and, if the right approach is adopted by taxpayers and their advisers, rather than depressing the economy, depriving citizens of much needed resources for building fair societies, tax planning should in fact enhance the economy and assist those most in need to develop. What, then, is the right approach?

The evasive form approach

All too often, the approach taken to tax planning relies on form rather than substance. A legal framework is drawn up to achieve a supposed “optimum” tax position - no or low corporate tax on profits, reduced withholding taxes on interest, dividends and royalties, the ability to rely on double tax treaties and with minimal or no taxes on exit. Usually the framework is not transparent. The business is then "squeezed" into this framework, which in fact does not represent the real ownership structure, mode of operation or business objectives of the taxpayer. The "tax tail" is wagging the business purpose. Such arrangements inevitably fail, as they generally rely on non disclosure, and once examined by tax authorities, they will fall down on beneficial ownership issues, tax residence issues and permanent establishment issues. Most tax authorities would not consider this to be tax planning but rather, tax evasion.

The substantive business approach

The correct approach to tax planning is, in our view, the absolute contra of the above. The objectives and business strategies of the taxpayer (at the shareholder and corporate level) must firstly be fully understood, for example, what is their core business, who are their customers, where are their markets, what are their short term and long term strategies, what is their source of funding and the expected return on equity. With this information to hand it is then possible to design a structure that accommodates the business strategies and objectives whilst at the same time achieving tax efficiencies. The resultant business structure is real, staffed with real people and real assets, doing real productive business in the locations necessary to achieve this tax efficiency as opposed to taxpayers who do not change the physical mode of their business but seek to achieve tax efficiencies by routing and parking earnings in a string of paper companies.

Tax policy as a tool for mobilizing resources, tax planning working in tandem

Many developing countries have extensive tax treaty networks, tax regimes that offer various incentives to establish business in their countries, low costs of overheads and extensive work forces that are eager and willing to learn new skills. They are also often close to the source of raw materials, finished goods or markets for goods and services. If international businesses are willing to relocate some of their resources to these locations, such as some experienced staff and infrastructure, to train and develop the local staff, provide safe and modernized work places for them and reward them appropriately, at probably still much lower costs than in their home countries, our opinion is that this should present a win- win situation for all. International businesses will reduce their costs, develop new talent pools and lower their tax burdens legitimately by relying on tax treaties, incentives and participation exemptions. The host countries will benefit from a larger tax base (broader income sources from active businesses) which will allow them to improve infrastructure, education and healthcare etc. and the local populace will be able to improve their livelihoods by learning and developing new skills and talents and enjoy a disposable income that will give them access to commodities and services to improve their overall standard of living.

Whilst we are not so naïve as to understand that entering a new or developing market is fraught with difficulties, such as understanding local customs and business practices, and training a "raw" workforce, we believe that multinationals, whilst financially benefiting from their ability to undertake global business, should be prepared to take reasoned "risks" to expand their reach in a way that all involved can benefit without exploitation.

A case in point

There have been reports about China's achievements in reducing the number of people who live in poverty. Over 600 million people were lifted out of poverty up to year 2008 ever since the open door policy was first introduced in late 1970s. It would be arrogant for us in the tax profession to attribute such success to the workings of tax incentive programs pertaining to the open door policy. However, we have the very fond memories of how foreign capital and businesses were attracted to set up factories and operations in China augmented by generous tax incentives along with appropriate tax planning, which enabled them to operate virtually tax free for years. This episode of tax history is a vivid proof that allowing business to capitalize on tax saving opportunities would not deplete the tax base but would, on the contrary, expand it. Tax base after all is not a technical concept but the true source of revenue which can only come from lively productive businesses. Thus the best way to protect a country's tax base is to attract and foster more creative businesses that can produce good profits as the source of revenue, providing the fiscal means for governments to honor their commitments to their people.