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Tax Havens

China's multi-faceted
connection with offshore
jurisdictions

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前言

这篇论文分成三个章节：第一个章节是关于整体的逃税天堂，什么是逃税天堂和离岸金融中心（offshore financial center， OFC），为什么这种地方在目前的全球化越来越重要，什么是在逃税天堂最通用的结构和战略；第二章是关于中国投资人采用逃税天堂的原因和方法；最后一个部分是关于中国常常采用的逃税天堂，就是开曼群岛（Cayman Islands）、英属维尔京群岛（British Virgin Islands，缩写为BVI）和香港。

什么是逃税天堂？

随着全球化，财富不再是物质的财富，而是金融的财富。财富性质的转变在目前的世界引起了很多的变化。全球化以前，每一个具有主权的国家与别的具有主权的国家界限分明，每一个国家关心自己的商务，处理自己的经济、自己的市场。二十世纪中期以来，每一个国家开始跟别的国家有业务的关系，国家开始从事跨境贸易：一个国家的市场不再与别的国家的市场分开，在世界上出现了一个全球的市场。金融的财富从一个地方轻易的转移到其它地方。在全球化的世界，在市场联合的世界，财富的性质形成了一些有特点的后果。

1934年瑞士制定了西方第一部《银行保密法》，由于很容易转移财富，瑞士的银行为了招揽外国投资人把他们的钱转移到瑞士帐户提供了优惠的利息：还有，瑞士的银行保障银行保密。瑞士的银行提供了外国投资人隐藏财富、漏税的机会。瑞士成为了吸收海外存款最多的国家和世界上最富有的国家之一。在历史上，瑞士是第一个提供逃税天堂服务的地方。

瑞士以后，在二十世纪其它地方也提供了类似的服务。尤其是，在加勒比海有许多小海岛成为了逃税天堂和离岸金融中心，比如说开曼群岛，英属维尔京群岛和百慕大（Bermuda）是最著名的。

为什么逃税天堂特别集中在那个地理位置？原因很多。

首先，加勒比海岛的土地很小，在它们的土地没有资源，为了发展，它们不可以依靠农业或者工业，因此为了发展它们自己的领土，唯一个办法是发展金融

业和给外国投资人提供金融服务。加勒比海的小海岛专攻了金融服务，并且成立一个优惠的税制：税率非常低，甚至没有征税。金融服务和宽松的税收环境让它们成为全球众多公司的注册地。这样它们引来了大量的财务来它们的领土，因为投资人希望在他们自己的国家漏税。此外，以上群岛都是英国在海外的一块自治属地，所以它们的经济和法律环境很发达、稳定，因此在它们的领土里从事生意没有风险，它们可以保护外国客户的权益，这也是一个招揽外国投资人的特点。

从 1960 年起，逃税天堂的采用推广了，越来越多国际大公司和个人为了逃避交税利用了法律漏洞。这种现象引起了国家政府和国际机构的注意，它们开始把逃税天堂的做法视为一个威胁，因此为了打击这种行为采取了措施。在国际机构中，经济合作与发展组织（经合组织，OECD）特别努力打击这种行为。

1998 年经合组织发表了一个报告，在那篇报告里提到了鉴识逃税天堂的判据，还有提议了反对有害的税制的方法，尤其是，经合组织要求所有的国家合作和努力。逃税天堂的主要特点是：在那个领土有非常低的税率或者没有征税，没有有效的信息披露，透明度不强，并且没有实质性的商务活动。如果在一个管辖区所有这些条件都存在着，很可能那个管辖区就是一个逃税天堂。

由于财富的性质，个人和公司很容易把它们的收益转移到加勒比海的逃税天堂，他们为了转移收益和漏税可以采用多种结构、战略等方法。

为什么中国与逃税天堂和离岸金融中心有关系？众多中国企业对逃税天堂趋之若鹜，无非有三个目的：转移资产、上市和避税。

总体而言，公司和个人把财务转移到逃税天堂的原因是漏税或者减少税款负担：对中国来说，这个原因也存在，但是最奇特的目的不只是在中国漏税。

自 20 世纪 90 年代以来，中国吸收的外商直接投资直线上升。中国已经是世界上吸收外资最多的发展中国家。 2003 年，外资投入仍然保持了继续上升的势头。从中国开始对外资开放的 1979 年到 2002 年，中国累计吸收的外商直接投资已达到 4462 亿美元。中国从 70 年代末期开始实行改革开放政策后，就给予外商投资企业一系列政策优惠，包括与国内本土企业不同的企业所得税税率、减免所得税、享受进出口权、减免进出口关税等等。从 1994 年起， 国内企业的所得税

税率统一为33％，而外商投资企业的税率为15%。

由于外资享受大量的优惠政策，这引诱国内资本通过海外改头换面，以外资的名义回国内进行投资。这种过程是指“往返投资”（round tripping)，即国内资本通过各种途径流往海外，又以外商投资的名义回到国内。

在对待外资企业的这一系列的政策优惠， 自然形成了巨大的吸引力，使得一部分国内资本通过各种方式钻政策空子，以“往返投资”的方式取得外资身份借以获得本来享受不到的政策优惠。因此，在内外资企业之间的政策落差，应当是导致大量“往返投资”的主要原因。中国的外商直接投资中，“往返投资”有可能占到30％-50％。

另外一个原因就是中国资本市场的缺陷。在中国国有企业和民营企业的待遇有很大的差异，国有企业很容易从国有银行获得融资，而民营企业获得融资有很大的困难。因此民营企业在逃税天堂注册，然后中国人可以以离岸公司名义到美国、香港等地方的资本市场上市。上市以后这些公司可以获得融资。

这两个原因是中国采用逃税天堂的主要因素。

为了在离岸资本市场上市和绕过中国政府对外资的限制，中国企业采用一个模式叫“可变利益实体”（Variable Interest Entity, VIE 结构）。特别是优质的互联网企业在离岸上市采用这种结构。

VIE 结构在中国被称为“协议控制”，是指离岸注册的上市实体与境内的业务运营实体好像是分离的，但是离岸上市实体通过协议控制的方式成为境内业务实体的实际收益人和资产控制人。到目前为止，该结构是海外上市的中国公司满足监管要求的标准模式。阿里巴巴、百度、新浪、京东商城等公司都采用 VIE 结构。

具体地说，中国跟三个逃税天堂有关系：开曼群岛、 英属维尔京群岛和香港。前二个真的被认为是国际的逃税天堂，而香港不是真正的逃税天堂，它却是所谓的“国际金融中心”。

开曼群岛位于加勒比海，它是英国在海外的一块自治属地。在开曼群岛农业

不发达、工业规模较小，旅游业和金融服务是两大经济支柱。尤其是银行业特别发达，全球最大的一些银行在那里开设了分行。金融业的成长受到开曼群岛政府赞成低税率和帐户保密的鼓励。开曼群岛完全没有直接税收，无论是对个人、公司还是信托行业都不征任何直接税。此外，它是著名的离岸公司注册地：公司注册的费用非常低、过程不长，因此在这里注册的公司和银行分行特别多。群岛的财政收入大部分来自这一部分。

具体地说，全世界最大的一些银行都在开曼群岛设有子公司或者分支机构；每年平均约有4300家公司在此注册和成立。这个小岛国之所以如此吸引外国投资人，主要是因为它的优惠的金融政策：它没有个人所得税、公司所得税、资本利得税、不动产税、遗产税等直接税。还有外汇在开曼群岛自由地进出，并且各部门对投资者的金融信息十分守口如瓶。

如此，开曼群岛获得了逃税天堂的称谓，也成为了世界最大金融中心之一，并且它和中国之间的资本流通很密集。

英属维尔京群岛和开曼群岛一样位于加勒比海，是英国在海外的一块自治属地。在英属维尔京群岛农业和工业不太发达、制造业规模较小，它主要依靠旅游业和金融服务业；它为了促进工业发展，实行了一个不征税的制度。在过去英属维尔京群岛的金融服务业发展得很快，为的是吸引许多外国投资人在国内投资；政府进行立法促进银行业、保险业及加强金融业。由于英属维尔京群岛的法律体系是参照英国普通法体系设立的，并由于明确和容易的国际商业公司（International Business Company，IBC）的法律，在英属维尔京群岛注册的公司深受国际社会欢迎。在英属维尔京群岛注册的国际商业公司在全球所赚取的利润均不要向该岛国政府缴税。英属维尔京群岛吸引了大量的跨国会计师等专家和国际的律师事务所；在这里也有一些银行和金融机构，但没有和开曼群岛那么多。当地的公司注册的设施很先进，公司注册效率很高。在过去的近20年来，在当地注册的离岸公司已经超过了400000家。英属维尔京群岛的“国际商业公司法”这一法律证明英属维尔京群岛公司在国际范围内受到比较大的欢迎。在英属维尔京群岛不存在着具体的关于公司资料保密的条件，但是政府要求公司呈报的资料很

少，各股东和董事的姓名不会被公开。另外，当地实施的英国普通法也规定了专业人士必须对客户资料保密。

英属维尔京群岛最重要的活动是对企业和个人提供外国公司注册业务，在这里注册海外离岸公司的优势很多：最大的好处是离岸公司可以享有课税极低，甚至于享有免税的优惠，这有利于企业进行各种财务交易的安排。此外，离岸公司更拥有高度保密性和较少的外汇管制。由于在英属维尔京群岛投资会避免征收利得税，一般跨国公司选择在这里注册离岸公司。

总体来说，在英属维尔京群岛注册公司的优势体现在几个方面：英属维尔京群岛公司商业运作方便，税收制度优惠；英属维尔京群岛公司完全保密，不需要申报受益者；不需要申报年利润和财务状况；海外离岸英属维尔京群岛公司被免除当地所有的税收并且公司的股份可以自由地买卖。由于这些优惠条款英属维尔京群岛吸引了很多外国投资者和外国投资。

这些条件都令英属维尔京群岛成为了全球上最著名的离岸金融中心之一，并且英属维尔京群岛和中国之间的资本流通很密集，尤其是从英属维尔京群岛对中国的外商直接投资很多。

香港的情况跟上述的两个逃税天堂的不同。从 1997 以后，香港是中华人民共和国的特别行政区，按照“一国两制”的原则它的政治和经济体系与中华人民共和国的有很大的分别。香港的经济体系以自由贸易、低税率和最少政府干预闻名；它是全球最自由的经济体，它最主要的贸易伙伴是中国内地，两个地方的联系很密切。

香港不是真正的逃税天堂，而是国际金融中心。它的低税率及简单税制对中国内地投资者非常有吸引力。还有，香港目前已经和中国内地等 34 个国家地区签订了避免双重征税的协定。香港的投资环境高度自由，是全球最开放的经济体系之一。它是高度法治地区：在香港法律制度健全、公开，司法完全独立，政府是廉洁、公正和高效，在世界上享有很高的声誉。此外，在香港没有贸易和投资的壁垒，并且进入市场的限制很少，没有一个行业是完全禁止私人和外来投资者参

与的。香港十分重视法治及维持市场的公平竞争。

香港在联结中国内地与国际经贸方面拥有许多优势，它一直是跨国公司进入亚太地区和中国内地的通路，同时它是中国内地企业设施“走出去”战略的重要中转站。除了这些好处之外，香港的股票交易所高级，对中国内地的企业和投资者非常有吸引力，许多中国内地企业在香港上市是为了融资。此外，在香港注册的企业很容易融入外国股票交易所。这是因为香港的政治和经济体系符合国际标准，因此在香港注册的企业和投资在国际市场受欢迎。

开曼群岛、英属维尔京群岛和香港这三个地方之前有密切的关系。中国企业常常在逃税天堂注册，然后在香港上市；中国的投资在这三个地方转动以后，再次回到中国内地。从中国对开曼群岛和香港的外商直接投资很多，中国也受到从英属维尔京群岛和香港的大量投资。

综上所述，很清楚逃税天堂和离岸金融中心在世界上有一个越来越重要的地位。改革开放以后，中国和逃税天堂的关系越来越密切，而原因发生了变化：2008 年以前在逃税天堂投资的最主要的原因是往返投资，就是由于外资享受大量的优惠政策，国内资本通过海外改头换面，以外资的名义回国内进行投资；2008 年以后，大部分的优惠政策取消了，所以最主要的原因不再是这类。目前最大的冲力好像是在外国股票交易所上市和融资，并且把外资在中国的禁止工业领域投资。通过在逃税天堂注册的企业中国投资者有效地绕过中国政府的限制。

Chapter 1
Tax Havens

1.1 Introduction

The principle of sovereignty[1] is the foundation of the modern state system. Each sovereign state has the right to define its own domestic laws and policies within its territory, and this right includes also the definition of the tax regime.

Each state is free to establish the form and the level of taxation, depending on the level of public goods and services that it wants to provide: it can set high level of taxes and high level of public spending or, on the contrary, a low level of taxes and a consequently low level of public spending. This is essentially a matter of internal policy, it is determined by domestic considerations and its effects concern only the domestic economy. During the twentieth century, each sovereign state established its regulation and taxation, and given that each state is free to take decisions based only on domestic concerns, the result is that there are many different variants of regulations all over the world (Palan 2010).

In the past, the global environment was different from today: there were many different regulations within countries, there were trade barriers and the economic activity of each state was essentially limited within the country borders. The flow of capital also was very limited. Even in the case of spillover effects on other economies, these effects were limited.

During the twentieth century, due to the globalization process, the situation changed completely. The globalization heavily affected the way of doing business: the trade and the investment process was no more limited within the borders of each single country, but became more and more international. The barriers to trade were removed, and the national economies, as a result, became more and more globalized and integrated.

It was created a complex set of relationships among countries, which involved not only the international relations between countries, but also the relation between

1 Each sovereign state has the right to write its own laws and pursue its own policies, including tax laws and regulations, within its own territory (Palan, Ronen, Murphy 2013: 18).

domestic policy of different countries. Therefore, also the taxation regime established within each country, which before affected only the domestic economy, began to have a potential impact on other countries' economies. This also increased the potential negative spillover of domestic tax policies on foreign countries (Weiner, Mault 1998: 601).

The globalization promoted the capital flows and increased its mobility, and fostered the creation of financial and capital markets; therefore, countries were encouraged to reduce the tax barriers in order to support capital flows. There was an emerging need of adapting tax systems in order to reflect the changes and development of the global environment.

The globalization process led to the creation of a global market, compared to the traditional domestic market, in which the new players are companies not linked to a single one country, as it was before, but operating at a global level. They are the so-called Multinational Companies (MNCs) or Multinational Enterprises (MNEs), which have to face an increased global competition of business.

MNCs are structured in a way that adapt them to a global context: their activities and functions are spread across different countries, and the physical location of a given function or service is not as important as it was before (OECD 1998). Hence, the rising importance of tax havens in a globalized world is due to the opportunity for individuals and companies to shift their legal residence, relocating it in countries with a low effective tax rate, without the need of physically move the company.

On one hand, globalization had positive effects on the development of new policies that stimulated international business, whereas, on the other hand, it also had negative effects, because the integrated global environment created new opportunities for individuals and companies to avoid and evade taxes: they have the opportunity to take advantage of the favorable and low taxation of some countries in order to pay lower taxes than they would have to pay in their home countries. These countries with low taxation are the so-called *tax havens*.

Tax havens can be seen as a consequence of the increased globalization of the world: the capital is more international and volatile, the economies are more and more integrated, and this created the opportunity for some countries to establish a deliberate

low taxation policy which has as primary objective the attraction of financial capital and other geographically mobile activities (OECD 1998).

The proliferation of tax havens and the increasing exploitation of offshore jurisdictions around the world was made possible by the change of the nature of wealth (Zucman 2015: 9), which is now essentially financial wealth. Tax havens and the increasing use of offshore finance can, to some extent, be considered as an inherent result of the interaction of global capitalism with the system of state sovereignty (Haberly, Wójcik 2015: 39).

The practices regarding taxation that are adopted by tax havens are considered harmful by the international community because they cause, as a result, the erosion of the national tax base of other countries, furthermore they divert the normal flows of capital and investment, because haven jurisdictions' tax policies are specifically designed to attract foreign investors and, because of this, they create a harmful tax competition among states.

Investors, considering both individuals and corporations,[2] operating in jurisdictions that impose low or zero taxation are able to minimize their tax liability in their home country but, at the same time, they still benefit from public goods and services provided in the home country, also if they don't contribute to the financing of these public spending.

Tax havens serve also as conduit countries for investment into other countries (Weichenrieder, Xu 2015): they attract FDI within their territory, but they are not the ultimate destination of such investment: investments are channeled through tax havens to be then redirected elsewhere. This role of tax havens as conduit countries originates the so-called process of round-tripping, which has increasing importance in particular in FDI into China.[3]

The increasing importance of the offshore FDI process also implies the fact that data related to FDI and trade are no more reliable indicators of the real structure of the global economy (Haberly, Wójcik 2015: 7), as they are biased by this distortion in the

2 The term corporation refer to an organization with its own legal identity which is separated and distinct from its legal owners, the shareholders (Simon 1998: 35).

3 The phenomenon of round-tripping and the pattern of FDI inflows in China will be discussed in the next chapter.

patterns of investment due to the financial attractivity of offshore location.

Usually, tax havens are small countries, with a population below one million, and they do not have a developed domestic industry or they have certain type of geographic disadvantages, for example an unfavorable location; therefore, they are usually dependencies of large countries. Some of the most well-known tax havens are small islands with territories below 23,000 km², which offer little in terms of natural resources (Jones, Temouri 2016: 241). Due to these factors, their internal economy is inefficient in generating sufficient profits and hence they take advantage of their right of establishing internal policies (Palan 2002): they exploit the opportunity that arise from the establishment of a low tax rate in order to attract foreign capital. Thanks to the increasing amount of foreign investment that their tax policy attracted, as Hines (2005) pointed out, they faced a very rapid economic growth.

Furthermore, it is possible to identify a common feature in tax havens and OFCs: often, they are common law jurisdictions, based on English law (Wilson 2014: 220). These territories are dependencies of the British Crown, such as Jersey, Guernsey and the Isle of Man; British Overseas Territories, as Bermuda, British Virgin Islands (BVI), Cayman Islands, Gibraltar and Turks and Caicos; also, they are former British colonies which became recently independent: Hong Kong, Singapore, Bahrain, Cyprus and Dubai (Palan 2015).

Tax havens and their utilization is an increasingly important issue in today's globalized world, characterized by complexity of systems and greater capital mobility: it has been estimated that the importance of such jurisdictions registered a significative growth around 2008 and 2015 (Zucman 2015) and, despite the attempts made on a worldwide basis to counteract this trend, it seems to be still increasing.

For this reason, it is interesting to investigate the nature of this phenomenon and the effects it has on world's economies. What tax havens are, why they are created, their characteristics and their uses by both companies and individuals in evading taxes, and the magnitude of the phenomenon in terms of data and statistics, are discussed in this first chapter.

1.2 Tax Havens

The country that can be considered the first tax haven in the world is Switzerland, which role in concealing wealth started around 1920 and, throughout the nineteenth century, had an increasing importance not only for rich individuals in Europe, but also for American ones, all wishing to hide wealth from home country authorities and benefiting from secrecy and tax benefits provided by Swiss banks.

Since 1980, Switzerland was no more the only financial center available to investors, because centers of offshore wealth management started to emerge all over the world, in Europe, Asia and the Caribbean, attracting the greater part of global capital flows (Zucman 2015: 24).

In the last twenty years, there have been made several studies about tax havens, carried on by academics, economists and international organizations such as the Organization for Economic Cooperation and Development (OECD) and also by organizations at regional level, like the European Union. Although tax havens have been highly studied and there is a lot of literature about them, there is no a precise and clear definition of the term "tax haven". There is no a scientific method to determine without any margin of error if a country is a tax haven; there have been provided only guidelines, that is, a set of characteristic features that can usually be found in tax haven jurisdiction and whose combination can identify a tax haven.

Tax havens manage the mobile part of wealth, which is the financial wealth, with the purpose of attracting capital flows sourcing from foreign countries within their territory. They are used for the purpose of avoiding taxation in high-taxed jurisdictions serving as "booking" centers, in which transactions occurring in those jurisdictions can be booked and, consequently, be subject to the taxation system within the territory that, in the case of tax havens, consists of minimal tax rates.

Hence, tax havens are precisely created to serve as "booking devices", in which contracts and transactions can be booked, which provides shell operations and in which can be established shell companies. Shell operations and shell companies, as the name suggests, are empty operations or entities that serve the unique function of locating offshore business activities that, otherwise, would be subject to high taxation in foreign

countries. It is very rare that business operations booked in tax havens really take place there.

Such jurisdictions often offer only a juridical residence, and their main attraction is precisely the ability to provide services to clients without the need for them of physically relocating there (Palan 2002: 163). Therefore, they can be described as merely "legislative spaces", whose legislations are created to facilitate business transactions carried out by non-residents (Palan, Murphy, Chavagneux 2013: 45).

Since the definition of tax haven is not fixed, a country that uses tax incentives in order to attract capital and that lead to the adverse effect of eroding the tax base of foreign countries is also referred to as "harmful preferential tax regime".

OECD provided a distinction between these two terms: the first, "tax haven", is referred to a country with no or nominal income taxes that even so is able to finance its public expenditure and, in addition, offers itself as a place that can be used by non-residence to minimize their tax liability in their domestic country; hence it contributes to the erosion of the revenues collected from income taxes in other countries.

Whereas the term "preferential tax regime" refers to a country that collects significant income taxes within the country, and in this way is able to finance its spending, but which, at the same time, presents a tax policy that, due to some features, potentially determines a harmful tax competition.

In order to refer to such low-taxation countries, recently, it is also used the term Offshore Financial Center (OFC), with the purpose of referring to a country that offers financial services to non-resident individuals in a size that is not proportioned with the needs of the domestic economy (Zoromè 2007).

These terms are often interchangeable, since the borders of their definitions are blurred and often one merges into another. A more specific investigation of their meaning and their defining characteristics will be given in paragraph 1.5.

One of the first and fundamental contribution in the identification and explanation of the key factors that help to identify tax havens and preferential tax regimes had been given by the OECD in its Report of 1998, which addressed harmful tax practices in OECD member and non-member countries, and the primary objective of its project was to discourage and counteract harmful practices.

The fundamental identifying characteristics pointed out in the Report have been recalled by the following studies and reused in every work that aimed to give a definition of what a tax haven is. After that, several other relevant studies have followed, and many important academics gave their contribution.

The OECD identified four key factors that can be find in tax haven jurisdictions; of course, there are many other contextual factors[4] that have to be considered in order to understand the complexity of tax havens environment, but the OECD criteria can be regarded as the starting point of any investigation.

1.3 Criteria to Identify Tax Havens

Tax havens make use of tax and non-tax incentives in order to attract financial activities and other activities in the service sector. As pointed out by the OECD, no or only nominal taxation is the starting point in order to assess whether a country is a tax haven.

In addition, a further evidence is given by the fact that the country offers itself as a place where foreign investors can escape their domestic tax liability. Another significant aspect is the limitation in the ability of other countries to obtain relevant information about investors in that specific country and, in general, the obscurity regarding activities that take place there. The combination of one or more of these factors, can lead to the identification of a tax haven.

As mentioned above, the absence of taxes or even a very low effective tax rate, in the case that a jurisdiction imposes taxes but the definition of taxable income is so restricted that, as result, a very little amount is effectively subjected to taxation, which is offered to non-resident companies and investors, is the necessary starting point to identify a tax haven. This is a well-known characteristic of tax havens, but is necessary to clarify the concept of “no or low taxation”: haven jurisdictions offer non-resident these tax incentives, collecting very few taxes from their financial activities, but at the same time they're able to raise sufficient revenues to operate and to finance their public spending.

4 A more detailed explanation will be given in paragraph 1.5.

This is possible because they separate the domestic economy from the preferential regime, that is, they "ring-fence" the regime: only non-residents can take advantage of the low tax rate, while resident taxpayers are charged a higher level of taxation. This enables tax havens to raise the revenues needed for its financing, while presenting themselves as a low or zero tax jurisdiction to foreign individual that wish to benefit of its taxation incentives.

Furthermore, it is important to notice that even if non-residents are allowed to benefit from really low tax rates, they are in some way taxed using other methods: as an example, haven jurisdictions may impose licensing and registration fees, or impose a sort of indirect taxation with the requirement of employ local people or applying other sort of custom, duty or property taxes (Palan, Murphy, Chavagneux 2013: 31).

Also, tax havens are able to offer low or zero taxation to non-residents activities because they are dependent jurisdictions, so they benefit from subsides from larger countries: as an example, they rely on those countries for their security, diplomatic relations, maintenance of their currency and other macro-economic matters. This enables them to shift some of these savings to non-residents by translating them into tax benefits (Palan, Murphy, Chavagneux 2013: 32).

The second factor is the lack of effective exchange of information for tax purposes with other countries. The inability to provide relevant information about investors may be the consequence of specific secrecy laws implemented by the tax haven jurisdiction, which prevent domestic financial institution from disclosing information about the identity of non-resident investors.

Even if there are no formal secrecy laws, the administrative practices in a country may in any case prevent the exchange of information, as an example it may be established that certain information regarding business transaction belong to matters of business secrecy, and they do not have to be disclosed under Article 26 paragraph 2 (c) of the OECD Model Tax Convention[5] (OECD 1998: 30).

Tax haven jurisdictions do not allow tax authorities to access to bank information

5 The paragraph 2 (c) of Article 26 states that in no case the provisions regarding the exchange of information should "be construed so as to impose on a Contracting State the obligation: […] to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy" (OE2014: 40).

for tax purposes, such as for the identification of tax avoidance cases or for impeding it; the strict application of the principle of banking secrecy and the non-disclosure of information allows true owners to remain undetectable.

It can be easily understood that one of the main reasons that make tax havens so appealing for foreign investors that wish to evade taxes is exactly the anonymity granted by those jurisdictions. Individuals, both in the case of a single investor or a corporation, can use tax haven to shift their taxable income from their home country into the offshore jurisdiction, and their real identity is protected and not disclosed to the foreign country's tax authorities.

The anonymity is provided both by the ineffective exchange of information and by the use of particular techniques, that will be extensively discussed later, to disguise the real identity of non-resident investors. Hence, the absence of an effective exchange of information and the context of anonymity and obscurity may also facilitate non-only the tax evasion but also the money laundering.

The second factor is, for the above-mentioned reasons, tightly connected and combined to the third one, which is precisely the lack of transparency, with regard to the jurisdiction's administrative tax practices and the existence of any non-transparent activity.

In tax haven jurisdiction, the administrative mechanism does not abide by transparency rules and prevent tax authorities to effectively operate (Carbone, Bosco, Petese 2015: 5). This opacity, more than the tax rate, can be considered the distinguishing feature that characterizes tax havens and distinguishes them from other preferential tax regimes (Palan, Murphy, Chavagneux 2013: 32).

The absence of transparency can be observed in various aspects of the jurisdiction: first, it can be observed in the case that favorable administrative regulations are allowed, and in the case there is the possibility for taxpayers to negotiate with tax authorities. In this case, the jurisdiction opens the possibility for some taxpayers to face lower effective tax rates, granting an unequal treatment. The principle of transparency claims that the administrative rulings, whether regulatory, substantive or procedural, are public and well-known, and that they are equally applied to all taxpayers.

Also, lack of transparency may arise in the case that some administrative practices

applied are not in compliance with the fundamental procedures underlying statutory laws, or, similarly, in the case that the fiscal regulations are contrary or not compliant with the domestic law (OECD 1998: 29). In both cases, non-transparent and not publicly disclosed practices allow taxpayers to negotiate with authorities and allow them to take advantage of discriminatory favorable practices. The inequality of treatment within a jurisdiction is one of the basic features that characterize tax havens and harmful preferential tax regimes.

The OECD also identified another important distinguishing feature, that is the absence of substantial activity within the territory of the state. The lack of substantial activities is a significant evidence because it indicates that the country wishes to attract transactions and investments that are merely tax driven. It means that apart from the opportunity to minimize the level of income taxes to be paid, that country is not able to offer any other sort of advantages that attract substantial business activity within the territory. Therefore, this characteristic suggests that the jurisdiction is offering itself as a tax haven for non-residents' tax minimization purposes.

In addition to the four main criteria identified by the OECD, there are other features that can be observed in tax haven jurisdictions. Usually, tax havens are small countries and their population is under one million, and they are generally more affluent than other countries, but what often is not given enough relevance is the aspect of the quality of governance, which appears to be a fundamental factor in determining if a country has the probability to become a tax haven.

One of the characteristic shared by all the tax havens in the world is the political stability and the effectiveness of the government. As stated by Dharmpala and Hines (2009:1), “there are almost no poorly governed tax havens”, and the improvement of the quality and effectiveness of the domestic government highly increase the probability for a small country to become a tax haven.

The explanation of the importance of the governance quality is that well-governed countries have a higher probability to be able to exploit the benefits deriving from the increased flow of capital attracted, more than poorly-governed countries would be able to do; also, tax policies can be considered as related to and influenced by the country governance (Dharmapala, Hines 2009).

A convincing definition of what a tax haven is, is the one proposed by Palan, Murphy, Chavagneux, which labels tax havens as:

> Jurisdictions that deliberately create legislation to ease transactions undertaken by people who are not resident in their domains, with a purpose of avoiding taxation and/or regulations, which they facilitate by providing a legally backed veil of secrecy to obscure the beneficiaries of those transactions.[6]

This definition effectively sums up all the key factors identified by the OECD and academics that have followed regarding tax havens and properly gives an effective idea of the concept of haven jurisdiction.

Throughout the years, there have been provided several lists of tax havens, both by individual studies by scholars and by international organizations; although there may be slight variations in the names included in those lists, there are countries which are recurrent in each of them, and that are constantly identified as tax havens. A comprehensive list is showed in Table 1.

Table 1. Countries listed on various tax havens lists

Caribbean/West Indies	Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands
Central America	Belize, Costa Rica, Panama
Coast of East Asia	Hong Kong, Macau, Singapore
Europe/Mediterranean	Andorra, Channel Islands (Guernsey and Jersey), Cyprus, Gibralter, Isle of Man, Ireland, Liechtenstein, Luxembourg, Malta, Monaco, San Marino, Switzerland
Indian Ocean	Maldives, Mauritius, Seychelles
Middle East	Bahrain, Jordan, Lebanon
North Atlantic	Bermuda
Pacific/South Pacific	Cook Islands, Marshall Islands, Samoa, Nauru, Niue, Tonga, Vanuatu

6 PALAN, Ronen MURPHY, Richard CHAVAGNEUX, Christian (2013), *Tax Havens. How Globalization Really Works*, Cornell University Press, Ithaca, US, p. 45.

West Africa	Liberia

(Source: Gravelle 2015: 4).

1.4 Criteria to Identify Harmful Preferential Tax Regimes

The OECD, in the Report of 1998, made a distinction between tax havens and harmful preferential tax regimes. Harmful preferential tax regimes can be find in both OECD members and non-member countries, and such regimes are designed with the special purpose of acting as a conduit in order to make capital flows across borders; also, they include special provisions regarding tax practices, both included in the domestic tax system or in the form of legislations out of it, that makes the country a favorable location for holding passive investments or for booking paper profits (OECD 1998).

As tax havens do, these regimes have the potential to create a harmful tax competition among countries, and for these reasons are addressed by the work of the OECD, aimed at identifying and counteracting such harmful tax practices. The objective of the implementation of preferential tax regimes in a country is to attract activities that can be easily shifted from one place to another, that are financial and service ones.

The starting point in order to identify a harmful preferential tax regime is the absence of taxation or a low effective tax rate on the relevant income. This first criteria can be find identical in the above-mentioned factors to identify a tax haven. In order to assess whether a jurisdiction is potentially harmful, no or low taxation is the crucial starting point. A zero or low effective tax rate may be the result either of the establishment of a low rate itself, or because the definition of the taxable income is so narrow that a very limited amount of income is effectively taxed.

The second essential element is the so called "ring-fencing"[7] of regimes, which means that the preferential regime is partly or fully isolated from the domestic economy

7 "Ring-fencing" is often used as a regulatory solution to problems in various sectors, as in banking, finance, public utilities and insurance. It can be used in different context; with regard to the regulatory context, as an example, it indicates the legal deconstruction of a firm in order to optimally reallocate and reduce risk. Apart from the application for tax purposes discussed here, ring-fencing is the regulatory solution to a wide range of financial and business problems (Schwarcz 2013).

(OECD 1998: 26). When a regime is ring-fenced,[8] the domestic market is separated and thus not affected by the incentives offered by the country to non-resident investors; in this way, the potentially negative spillover effects created by tax incentives will impact only on foreign countries' tax base. In this way, the economy of the country offering the regime will not be affected by the preferential tax legislation offered to non-residents.

The need for a country to protect its domestic economy and to ring-fence the regimes is a clear indicator that those regimes are considered to be potentially harmful. There are two forms of ring-fencing: first, the regime may restrict the benefits to non-residents, and prevent resident individuals from taking advantage of the preferential legislation, in this way ensuring that the negative impact of those legislation will be totally borne by other countries; second, the regime may forbid to non-resident investors, that take advantage of the preferential regime, to operate in the domestic market.

As an example, the country may establish that the tax privileges are not applied to operations carried on in the domestic market, or that they will be canceled in the case that the non-resident investors start operating within the domestic economy (OECD 1998: 28). Furthermore, the OECD also added that, in some cases, the ring-fencing of regimes may be achieved by the prohibition to make business transactions using the domestic currency, in this way keeping the domestic monetary system isolated from the preferential regime.

The third and the fourth factors are, as seen before regarding to tax havens, the lack of transparency and the lack of effective exchange of information. As mentioned above, the absence of transparency is observed in administrative practices, which are established in such a way that allow non-resident taxpayers to benefit from a favorable tax treatment and are non-publicly disclosed. These practices are shielded from foreign authorities' inspection thanks to the constrained exchange of information from the jurisdiction that applies the harmful tax regime; such jurisdiction may enact special secrecy laws or may have administrative policies or practices that effectively prevent the disclosure of relevant information.

8 "Ring fence" is defined as the isolation for tax purposes of a group of activities from other activities, that may be used to ensure that only costs incurred within the ring fence may be set against the revenues arising from the activities within the ring fence. (Simon 1998: 130).

Hence, the factors to identify harmful tax regimes may, to some extent, overlap to those identifying tax havens. Tax havens are, de facto, harmful preferential tax regimes: their administrative and taxation practices produce spillover effects on foreign countries' tax base, and they have a negative impact on them resulting in the erosion of other countries' tax base. On the other hand, preferential tax regimes present features that may produce the same adverse impact, but the extent to which they negatively impact other countries' economy depends on the combination and application of these features.

Some preferential tax regimes are established also in OECD member and non-member countries, with the purpose of appealing non-resident investors and attracting capital and investment (OECD 1998), but it is not given that they are established with the special purpose of eroding other countries' tax base, and also it is not certain that they will create harmful tax competition among states.

Harmful tax competition is a result of the combination of various features within the jurisdiction, it is not only the low taxation itself that constitute harmful tax competition: there may be jurisdictions that impose low level of taxation but are not engaged in harmful tax competition (Weiner, Mault 1998: 603). Hence, this is an important point to remember, and it fundamentally distinguishes the nature of tax havens from other preferential tax regimes.

1.5 Offshore Financial Centers

After discussing the characteristics of tax havens and harmful preferential tax regimes, it is relevant to pay attention to another appellative which, especially in recent years, has widely spread, that is “Offshore Financial Center (OFC)”.

As for the previously mentioned two definitions, also with regard to OFCs there is no a commonly shared and exact interpretation of the term, and there is no a framework able to provide a uniform classification. This term is often interchangeable with the expression “tax haven”, and a country referred to as tax haven sometimes may be defined OFC. In this paragraph, the nature and the characteristics of such centers will be investigated.

OFCs play an important role in the international financial system, and they

essentially serve as financial intermediaries for cross-border capital flows (Lane, Milesi-Ferretti 2011: 2). They started to have an impact on international financial markets since 1970s[9] and, in general terms, they can be defined as offshore hubs that capture a great proportion of global financial flows and business activity (Zoromè 2007: 4), and that have within their territory a large number of financial institutions that are primarily engaged in business with non-residents (IMF 2002). Their intrinsic nature is to serve as mere intermediaries, and for this reason they are not the primary source or the final destination of cross-border investments channeled through their domain (Lane, Milesi-Ferretti 2011: 2).

OFCs have been the subject matter of several researches and studies undertaken by a number of scholars and, as a result of those analysis, we can identify some recurring characteristics that can be used in identifying OFCs.

First, as mentioned above, the main business of OFCs is primarily directed towards non-residents. In addition, the jurisdiction offers a favorable regulatory environment and a low or absent taxation, and this should be the result of an intentional effort aimed at attracting a huge proportion of financial flows and business activities from other countries (Zoromè 2007).

Apart from the low level of tax rates, one of the more appealing aspects for foreign investors is the lightly regulated environment and the absence of substantial control and, in addition, also the absence of requirements regarding the disclosure and exchange of information, which are heavily imposed in high-regulated countries.

All these contextual aspects allow non-residents to operate in a business environment that is both favorable, from the taxation and regulatory point of view, and non-transparent, ensuring secrecy and anonymity in the operations. The lack of transparency is also achieved through the exploitation of complex ownership structures (IMF 2002) located in those jurisdictions.

Furthermore, an intrinsic feature of such centers is that the size of their financial sector is not proportionate to their domestic financial needs, and far exceed the needs for financing the domestic economy; this is precisely the result of the offerings of financial activities to non-residents (Zoromè 2007: 7). Therefore, given the high

9 According to other sources, their take off was already started in the late 1960s (Henry 2012: 40).

exporting of financial services to non-residents, as proposed by Zoromè, an indicator of the status of OFC is given by the proportion between the amount of its net exports of financial services and the level of the domestic financing needs or GDP (Zoromè 2007: 8). If the level of export of financial activities is far higher than the domestic needs, this is a clear indicator that the jurisdiction is attempting to attract financial activities undertaken by non-residents, offering itself as a favorable location for their offshore business.

Also, OFCs provide the legal domicile to a huge number of entities, such as shell companies, trusts and Special Purpose Vehicles (SPVs), which primarily perform custodian functions, which means that they hold and manage assets and investments on behalf of non-resident clients (Zoromè 2007: 9).

Other relevant features observed in OFCs are that transactions are usually set using currencies that are not the domestic currency of that country, and that those centers are separated from major regulating units, by geographic or legislative point of view (Zoromè 2007: 5). Moreover, the International Monetary Fund (IMF) describes the banking system in OFCs as essentially "entrepôt business", that is, it provides temporary location for external funds, and it holds external accounts that far exceed those associated with business activities within the domestic economy (IMF 1995).

In OFCs it is common that the financial institutions have little physical presence, or even no physical presence, and these centers usually serve as mere booking devices, in which are booked transactions that in fact take place elsewhere. The activities and the financial intermediaries that can be found in OFCs are those that are typically observed also in tax havens. In the banking sector, there are offshore banks established by large multinational corporations, that manage their offshore operations or facilitate their financing; also, there are subsidiaries established and fully owned by large banks located in other countries, that provide offshore fund administration services to their onshore parents (IMF 2002). Also, International Business Companies (IBCs) and Special Purpose Vehicles (SPVs) are incorporated there, and there is also the presence of insurance companies, both in the form of captive insurance companies established by foreign commercial firms and as subsidiaries of insurance companies located in foreign countries. All these structures can take advantage of the various forms of incentives and

benefits that such structures enjoy in tax havens.[10]

OFCs play an important role in the international investment positions of a large number of countries. Apart from providing the location for the incorporation of various type of entities and offering offshore bank accounts to non-residents, their financial services also include cross-border assets and liabilities of various kind, such as portfolio equity, that can take the form of shares in corporations or shares in collective investment schemes, for example mutual funds[11] or hedge funds;[12] but also, portfolio debt, other types of debt and FDI (Lane, Milesi-Ferretti 2011: 5).

As noticed before, OFCs play the role of intermediaries in the flow of cross-border capital and they are not the final destination of investment that pass there; the investments routed through their jurisdictions are destined to other final locations or, in some cases, they are intended to be re-invested at a later time in the domestic market from which they originated: this circumstance is the so called "round-tripping" (Lane, Milesi-Ferretti 2011: 6).

The tax advantages accessible to individuals and corporations in operating in OFCs are extensive. Individual customers can use investment vehicles such as trusts or private companies, and have the opportunity of holding bank accounts that they do not record in their country of residence; large corporations can incorporate there, establish offshore subsidiaries or other financial intermediaries in order to achieve various financial benefits, such as the minimization of the taxable income in their home jurisdictions.

After the investigation of the characteristics of OFCs, their role in global financial

10 This part will be extensively discussed in paragraph 1.6.

11 A mutual fund is an investment vehicle made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money maket instruments and similar assets. It is a professionally-managed investment scheme, usually run by an asset management company, that invests the fund's capital and attempt to produce capital gains and income for the fund's investors (source: http://www.investopedia.com/terms/m/mutualfund.asp, accessed 1/02/2017).

12 Hedge fund is an alternative investment vehicle available only to sophisticated investors, such as institutions and individuals with significant assets. Like mutual funds, hedge funds are pools of underlying funds, but there are some differences: they are less regulated, and they can invest in a wider range of securities than mutual funds can, and for this reason they use more sophisticated and risky investments and techniques; also, hedge funds are typically not as liquid as mutual funds are, and they have a "lockup period" during which investors cannot sell their shares. As a result of these factors, hedge funds are typically open only to a limited range of investors: hedge fund investors must be "accredited," which means they must earn a minimum annual income, have a net worth of more than $1 million, and possess significant investment knowledge (source: http://www.investopedia.com/terms/h/hedgefund.asp, accessed 1/02/2017).

system and their use by individuals and corporations, through a wide range of strategies and structures, it is possible to notice that their intrinsic nature is essentially the same of the previously discussed tax havens. The key factors that identify both of them are the same: they are places that primarily offer financial services to non-resident clients, they offer favorable tax rates and lightly regulated environment, they guarantee anonymity and secrecy to investors, and they facilitate the purpose of tax evasion.

In broad terms, they can be considered synonymous, but specifically they emphasize different aspect of the same issue: tax havens are political jurisdictions, which have the sufficient autonomy to create a preferential legislative framework, including taxes, finance and other aspects of regulation; whereas the term OFC refers more to the set of financial activities provided there, rather than a geographical location. The term "offshore" stresses the fact that transactions booked in those centers in reality take place elsewhere (UNCTAD 2014: 171).

Table 2. List of OFCs

1. Andorra	17. Hong Kong	33. Panama
2. Anguilla	18. Ireland	34. Samoa
3. Antigua and Barbuda	19. Isle of Man	35. Seychelles
4. Aruba	20. Jersey	36. Singapore
5. Bahamas	21. Lebanon	37. St. Kitts and Nevis
6. Bahrain	22. Liechtenstein	38. St. Lucia
7. Barbados	23. Luxembourg	39. St. Vincent and the Grenadines
8. Belize	24. Macao	40. Switzerland
9. Bermuda	25. Malaysia (Labuan)	41. Turks and Caicos Islands
10. British Virgin Islands	26. Malta	42. Vanuatu
11. Cayman Islands	27. Marshall Islands	43. Dominica
12. Cook Islands	28. Mauritius	44. Grenada
13. Costa Rica	29. Monaco	45. Montserrat
14. Cyprus	30. Nauru	46. Palau
15. Gibraltar	31. Netherlands Antilles	
16. Guernsey	32. Niue	

(Source: Zoromè 2007: 23).

1.6 Legal Structures Used by Individuals and Corporations

The general presumption in international tax systems is the residence tax income, that is the right of a country to tax the income produced by activities within its territory, or by foreign activities carried on in other countries by resident corporations (Kudrle, Eden 2003).

In the past, when cross-border trade was limited and corporations were located in a single country, and their business was primarily run there, their corporate income was subject to the provisions of the domestic taxation system: as the relevant income was produced within the country, it was taxed there. Since globalization lead to the rise of cross-border trade, and corporations became multinational corporations (MNCs), their business is no more physically located in a single place, but is often spread among subsidiaries across different countries and is often composed by intangible activities, such as financial and service ones, thus is difficult to precisely determine where they are effectively undertaken. Hence, this international environment allows corporations to exploit the loopholes[13] of the current legislation to avoid taxes (Zucman 2015: 102).

Multinational corporations' own subsidiaries are located in different countries, and it is difficult to precisely determine the income earned by each one, which has to be taxed; in fact, multinational corporations can easily shift profit from one subsidiary to another, changing the location in which the profit appears to be earned, affecting in this way also the taxation to which that profit is subjected: they can shift it in low-taxed countries, minimizing their tax liability.

In particular, multinationals that work with a high level of intangible assets or in the service industry are more likely to invest in tax havens and establish subsidiaries there, compared to companies that work in traditional sectors or less-technologically intensive multinationals. Given the ease of transferring the ownership of intellectual properties, rights, patents, trademarks and licenses to offshore jurisdictions, multinationals that deal with those kinds of intangibles have a higher likelihood of exploiting offshore jurisdictions' offerings in order to reduce their tax liability in the country of residence (Jones, Temouri 2016: 238).

13 Regarding taxation, a tax loophole is a feature of the tax system which allows taxpayers to reduce their liability (Simon 1998: 148).

Tax havens and offshore jurisdictions are widely used not only multinational groups but also, in large measure, by wealthy individuals, which utilize offshore jurisdictions' bank accounts in order to hide their income and assets from their domestic tax authorities (Weichenrieder, Xu 2015: 4). In many cases, in technical terms, the financial services provided are legal, but they also provide the opportunity for foreign clients to avoid taxes in their domestic countries (Zucman 2014: 138).

In addition to banking services, the fundamental service that tax havens offer to both individuals and corporation is, precisely, the relocation, that is achieved by shifting their residence from the domestic country to the offshore jurisdiction; this simple strategy allows both individuals and corporation to escape the domestic taxation and benefit from the favorable tax rates in haven jurisdictions. For corporations, the relocation can be achieved by moving their headquarters to the low-tax jurisdiction, or by reincorporating there in order to minimize their corporate taxation.

Both for corporations and individuals, the relocation may be physical, that is, the corporation or individual physically move there, or may be obtained through several strategies, which will be investigated later in this section.

Apart from the physical relocation, that in some cases may be laborious to put into effect, tax havens offer to non-foreign clients, both in the case of a natural person or a corporation, the possibility of a legal separation of ownership: the distinction between the beneficial owner of an asset and the asset or income, whose ownership cannot be traced back to the real owner. Hence, the strategy of tax havens is based on the possibility to shift the legal residence without physically moving (Palan 2002: 153). The legal separation between owners and assets held in haven jurisdictions can be achieved using various structures and methods, each one benefiting from the secrecy provided in those locations (Sharman 2006).

In tax havens and offshore jurisdictions, individuals make a large use of “sham corporations”, that is, an individual, intended as a natural person, who is the owner of an asset, transfers the ownership of such assets to a corporation established in a haven jurisdiction, which act as a depository for such funds. This strategy is adopted with the purpose of disguising the identity of the real owner of assets held in tax havens in order to avoid taxation in the countries of residence.

Tax havens are specialized in offering such services to non-residents, providing an incorporation service and domicile location for entities set up by individual customers. In particular, the major jurisdiction specialized in shell corporation establishment is the British Virgin Islands (BVI) (Caruana-Galizia, Caruana-Galizia 2016: 23).

Multinational corporations exploit the existing loopholes in legislations in order to manage their international tax planning,[14] which means that corporations that run cross-border operations and that raise profits in different countries, have to effectively manage the allocation of such profits for tax purposes; they obviously aim at taking advantage of the different level of taxation in different jurisdiction to minimize their corporation tax liability.

The inconsistence between different countries' regulations allows multinationals to carefully choose the location in which establish their subsidiaries for tax purposes; in this way, that they can benefit from the tax incentives offered by low-tax jurisdictions for reducing their corporate tax burden (Zucman 2014: 124). This is what is called "treaty shopping", which is precisely the exploitation of loopholes in the legislation, treaties inconstancies and double tax treaties.

Originally, double tax treaties were intended at preventing the double taxation of profits earned by multinationals, which operate in different countries and earn profits within different territories. In fact, double taxation is defined as

> The imposition of comparable taxes in two or more States on the same taxpayer in respect of the same subject matter and for identical periods".[15]

Without these rulings, the income would be taxed both in the foreign countries in which it is raised, and in the domestic country in which the multinational is located. Thanks to these treaties, the double taxation is avoided and a single taxation is applied only in the country where the profits effectively occur.

Double tax treaties were intended to offer a fair allocation of taxation and an

14 Tax planning is the arrangement of the financial affairs of an individual or a business which has the objective of reducing the overall tax liability, to the extent that this is compatible with other objectives (Simon 1998: 150). The purpose of tax planning is to ensure tax efficiency, making the elements of the financial plan working together in the most tax-efficient manner possible.

15 VOGEL, Klaus (1986), "Double Tax Treaties and Their Interpretation", *International Tax and Business Lawyer*, 4, 1, p. 6.

equitable tax burden for multinationals that undertake business operation on a cross-border basis; however, the existence of these treaties is exploited by those multinational groups not to better allocate their tax liabilities, but to avoid them, taking advantage of low-tax jurisdiction in order to minimize their tax burden. When they are used in this manner, it is clear that the original aim underlying the creation of these kind of treaties is totally lost, and that they enhance tax avoidance and evasion through the practice of treaty shopping.

Profit shifting is only one of the numerous techniques that corporations can use in order to avoid taxes; there are many different structures that can be employed in order to achieve this purpose. These structures are likely to be as complex as possible, in order to increase the potential of jurisdictional arbitrage and to maximize the layers of secrecy that can be achieved through the establishment of such structures (Haberly, Wójcik 2015: 7).

Together with the previously mentioned relocation and the profit shifting, one of the most used techniques is the manipulation of transfer prices; multinational corporations make also large use of structures such as trusts, protected cell companies, limited liability partnership (LLP) and special purpose vehicles (SPVs). All these structures are used to disconnect wealth hidden in tax havens by their real owners (Zucman 2015: 42). All the main techniques and the most commonly used structures will be analyzed in this section.

1.6.1 Manipulation of Transfer Prices

Transfer pricing refers to the rules and methods adopted between enterprises under common ownership or control in order to price transaction among them; hence, this is a perfectly legal practice for corporations owning different subsidiaries that have to sell goods or services one to another.

However, the manipulation of transfer prices[16] is the major strategy used by firms to shift profit from high-taxed countries to low-taxed ones.

This method consists in the selling of goods and services by firms in high tax

16 The use of a pricing system with respect to the transfer of goods and services between affiliates within a large organization (Simon 1998: 156).

jurisdiction to affiliates in low tax jurisdictions at a very low price, lower than the price that would be fixed if the parties were unrelated, that is the market price. Transactions among subsidiaries within the same group should follow the "arm-length[17] principle", that is the selling of goods and services with a price fixed using as a reference the market price for those goods and services, in order to properly reflect income (Gravelle 2015).

Basically, the manipulation of transfer prices is a technique that consists in misinvoicing for trade transactions (Palan, Murphy, Chavagneux 2013). The basic application of this method is simple: the parent company, or affiliates, in the high-taxed jurisdiction sell goods or services at a low price to the affiliates in the low-taxed jurisdiction, and then the affiliates sell those goods and services fixing a high price to the affiliates located in the jurisdiction with a high taxation. In this way, the income that appears in the high-taxed jurisdiction is very low, due to the little revenues obtained from these transactions, while the relevant income is effectively earned in the low-taxed jurisdiction, and will be taxed according to the tax rate applied there. In this way, the profit is shifted from one entity to another within the same group, and it is realized the purpose of relocate the taxable income in a jurisdiction where the taxes to be paid on that income are very low (Zucman 2015).

Going into detail, the misreporting for trade transactions between affiliates can be accomplished with the following techniques: under-invoicing the value of goods traded from the high-taxed jurisdiction to the tax haven, and the goods are then sold by the affiliates in the tax haven at the proper price, generating an excess of revenue that is retained in the tax haven; over-invoicing the value of imports from the tax haven to the high-taxed jurisdiction, that is the step following the previous mentioned one; also, misreporting the quality or the quantity of products, in order to justify the under- or over-invoicing mentioned before. Lastly, corporations can also create fictitious transactions for which a payment has to be done (Palan, Murphy, Chavagneux 2013: 69). These are ways in which corporations can use the legitimate practice of transfer prices to achieve the illegal purpose of shift profits and avoid taxes.

In order to be legitimate, transfer prices have to be fixed according to the price

17 The concept of arm's length describes transactions between parties dealing with each other independently (Simon 1998: 8).

that would be used if the parties are unrelated, which means taking the market price as reference. The reference price is easy to be identified when the goods traded are tangibles one, and similar transactions can be replicated by other firms, so that prices can be easily compared; the problem arises when the transaction concerns intangible assets or intellectual property: is extremely difficult to establish the proper price of patent, logos, labels or algorithms, because their value is not easy to quantify (Zucman 2015: 104).

Because of the unique nature of these kind of assets, there are no benchmark in order to make a comparison and determine which is the proper price at which they have to be traded, and in many cases the market price even does not exist (Zucman 2014: 127); multinational groups are free to charge very little for these transfers to affiliates located in places, such as tax havens, that apply a low or zero corporate income tax rate. Therefore, because of the absence of terms of comparison, is difficult for authorities to detect the illegal practice and the purpose of tax evasion.

1.6.2 International Business Company (IBC)

Another instrument that can be adopted in order to shift profit to tax havens is the International Business Company (IBC), which is a type of company that has been set up by haven jurisdictions specifically for allowing corporations to take advantage of it for tax avoidance purposes.

IBCs are limited liabilities companies[18] established in tax havens as subsidiaries of parent companies located in other countries, or as independent companies; this structure allows companies to achieve the purpose of relocation of the business in low-tax jurisdictions.

IBCs established in tax havens can have different functions: they can be used in order to own and operate business there, to raise capital by issuing bonds and shares, or in order to raise capital in other ways (IMF 2002). Also, they can be used for the legal possession of property rights, for managing investment funds and as a part of complex financial structures. (Palan, Murphy, Chavagneux 2013: 85).

18 Legal arrangements such that the shareholders' liability is limited to the amount of capital they have invested (Simon 1998: 94).

Often, in order to disguise the relationship between the entity located in the tax haven and the parent company in the country from which the profit is intended to be shifted, there is no a direct connection between them: the entity appear to be an external business partner of the parent company, whereas, in reality, it is owned and managed by the company itself. In order to make difficult, or even impossible, to trace back the identity of the real owners, the subsidiaries or affiliates created in the tax havens are part of a complex network of companies; this network allows to efficiently conceal the ultimate owner of the group of companies.

It is frequent also the use of letterbox companies or domiciliary companies (Carbone, Bosco, Petese 2015: 452), which are built exactly to achieve the aim of anonymity: they appear to be independent companies but, as the name suggests, they are fictitious companies that do not perform substantial operations. In fact, they merely act as a repository for the business the parent company wish to shift to the tax haven.

The profit shifting from high-taxed countries to tax havens can be achieved using two main methods through IBCs. One strategy is to set up an IBC as intermediate holding companies, which means that the IBC is owned by the parent companies and owns other subsidiaries, from which it collects dividend income and then loans it to parent company in the high-tax country; apart from this function of intermediate, the IBC does not perform any other substantial activity.

Another formula is the so called "inversion" (Palan, Murphy, Chavagneux 2013: 90), which involves the establishment of the IBC in the tax haven, to which the parent company shift the ownership, so that the roles are inverted: the parent company becomes a dependent subsidiary, and the new established entity plays the role of parent company.

The secrecy of ownership is the characterizing feature of IBCs, which makes them so appealing for the adoption in tax havens. Normally, limited liability companies are subject to regulations which are intended to protect shareholders and to avoid abuses; as an example, all existing companies should be registered on public registers, all relevant information about share capital and directors must be disclosed, the company should have a registered place of business and it is required to provide public annual accounts (Palan, Murphy, Chavagneux 2013).

On the contrary, these disclosure requirements are usually missing in haven jurisdictions, where there are no filing requirements and the information that elsewhere are publicly released are kept secret. Furthermore, IBCs incorporated in tax havens can be set up with one director only or, in some cases, it is also possible that tax haven residents may serve as nominee director; using this strategy, the identity of the real directors is disguised (IMF 2002). These expedients allow the ultimate owners to effectively disguise their identity.

The establishment of IBCs in tax havens is also facilitated by the low incorporation costs, and it is required only an insignificant licensee fee to be paid annually to the haven jurisdictions (Palan, Murphy, Chavagneux 2013: 86).

1.6.3 Protected Cell Company (PCC)

The structure of the Protected Cell Company (PCC) is composed by a parent level and many separated parts called "cells", which operate as independent companies but are actually part of a single legal entity.

The parent level is responsible for the overall management of the group, while the various cells operate independently one from another, and they have separated assets and liabilities; this feature effectively makes them autonomous operating entities. Their assets result as separated from those of the other cells and also from those belonging to the PCC (Carbone, Bosco, Petese 2015: 478).

The structure of the PCC is not clearly declared and, as the other structures adopted in tax haven operations, they are characterized by an overall opacity, so that is difficult to assess whether companies, bearing different names, are protected cells of a PCC (Palan, Murphy, Chavagneux 2013). In this way, the PCCs erect an obscure and impenetrable structure which serves effectively the purpose of operating business in tax havens while being shielded from the detection by authorities.

PCCs may serve several financial purposes, and for this reason several types of PCC exist: first, it may act as Special Purpose Vehicle (SPV), that is a legal entity separate from owners, but also can serve as basis for the establishment of complex

financial instruments, such as rent-a-captive[19] PCC, insurance PCC, associations PCC and offshore life insurers PCC (Carbone, Bosco, Petese 2015: 480).

1.6.4 Limited Liability Partnership (LLP)

The Limited Liability Partnership (LLP) is a limited liability entity characterized by a relatively simple structure, which serve the function to disguise the ownership of assets and promote secrecy. It has been developed in the last decade and are now widely used in tax havens (Palan, Murphy, Chavagneux 2013: 88).

This legal entity can be established even with only two members, that may be both natural or legal persons, and it is not required that they are resident in the jurisdiction in which the entity is incorporated. It legally exists in the tax haven, but it is not taxed there: the entity is not subjected to taxation, whereas its members are, proportionally to the capital they have provided (Carbone, Bosco, Petese 2015: 466); this means that members of these entities are taxed as if they undertook the transactions of an LPP. In this way is also possible the separation of legal ownership of assets from the location of the income that is obtained from the operations (Palan, Murphy, Chavagneux 2013: 88).

This type of structure is appealing for investors that wish to operate in tax havens shifting there their taxable income, because under the regulation governing the LPP the profit earned abroad is not taxed in the jurisdiction in which it is incorporated.

In addition to these advantages, members of LPPs can benefit of a double layer of protection, which arises from two factors: each member is liable only for operation undertaken by himself, and not for those undertaken by other members; furthermore, each member is liable only proportionally to the amount of capital provided by himself (Carbone, Bosco, Petese 2015: 467). For these reasons, it would be very difficult for authorities to assess the liability of members, allowing them to operate in tax havens using this structure under a minimal risk.

19 Rent-a-captive is an arrangement in which a captive insurer "rents" its facilities to an outside organization, thereby providing the benefits that captives offer without the financial commitments that captives require (source: https://www.irmi.com/online/insurance-glossary/terms/r/rent-a-captive.aspx).

1.6.5 Trust

Trusts are another common method used to operate in tax havens and to accomplish the purpose of tax avoidance; they are peculiar to Anglo-Saxon law (Palan, Murphy, Chavagneux 2013: 92).

Trusts are arrangements whereby a property is held by one or more trustees for the benefit of others (Simon 1998: 157). Also, as defined by Gorton and Souleles, a trust is a legal arrangement in which is set up a fiduciary relationship regarding some assets, in this construct the trustee has the duty to operate for the benefit of third parties (Gorton, Souleles 2007: 555).

This means that, by setting a trust, it is achieved the purpose of establishing a legal separation between individuals and their assets; by forming trusts offshore, it is thus possible to take advantage of the favorable legislation there (Sharman 2006).

The legal arrangement of trusts involves a settlor, which decides to establish the trust in favor of one or more beneficiaries, or with a special purpose. The settlor determines the transfer of the legal ownership of an asset to a trustee, which can be embodied in a natural person or an entity; the trustee is then responsible for the assets transferred by the settlor, and has to manage them in order to reach the goal for which the trust was established.

The trustee does not correspond to the beneficiaries, which are the ultimate individuals that have the right to benefit from the profits arising from the trust. For these reason, they are commonly used in tax havens and offshore jurisdictions in order to separate and distance the assets or income located there from their real owner and, in this way, making them no more accountable as a tax liability in the domestic jurisdiction (Sharman 2006).

There are different types of trusts, such as active trusts and bare trusts. As defined by Simon, the first, the active trust, is a trust in which the trustee has more obligations that simply handing over trust property when requested by a person entitled to it (Simon 1998: 3); whereas the bare trust is an arrangement in which there is no obligation on the trustee except to transfer trust property when requested by the person entitled to it. In bare trusts, there also may be tax implications, because all capital gains and losses are

those of the beneficiary and not the trustee (Simon 1998: 14).

Other forms that trusts may have are purpose trusts, which are set up in order to achieve a specific purpose rather than for beneficiaries, and charitable trusts, which, as the name suggests, have charities as beneficiaries (Gorton, Souleles 2007: 555).

They are adopted for tax avoidance purposes because they allow the real owner of the assets to transfer them to another entity, so that in the domestic jurisdiction he does not appear as the owner of those assets; however, trusts allow the settlor to maintain a certain level of control over those assets.

The advantage of this kind of arrangement is the legal separation of ownership, so that it cannot be traced back to the real owner: hence, he does not have to pay taxes on the income arising from those assets, and is subject to taxation in the country of residence.

1.6.6 Exempt Company

The Exempt Company (or Exempted Company) is a structure that has been developed in order to shield the merely fictitious nature of the entity and to prevent the detection by tax authorities.

This kind of company is incorporated under the legislation that regulates the establishment of the local companies and it is allowed to benefit from tax exemptions under the mandatory condition that all the transactions are operated by non-residents outside the territory of the haven jurisdiction (Geãmanu 2015). For this reason, this type of company can be considered a structure specifically created for tax evasion purposes because residents are not allowed to establish it.

Moreover, the establishment of an Exempt Company serves the purpose of making the company owned by non-residents appear to be located in the haven jurisdiction and to run consistent economic activity there, while remaining untaxed according to the local tax system (Palan, Murphy, Chavagneux 2013: 87). The appearance of a real presence and activity there prevent the company to be taxed in the high-taxed country from which the taxable income is intended to be shifted.

In exchange for the tax incentives guaranteed by this type of structure, only a

minimal incorporation fee and annual registration fee are required, and it is also offered the possibility to appoint a nominee director.

Furthermore, for the incorporation to be made is sufficient only one shareholder (Geãmanu 2015), and this minimal requirement makes the entity appealing for both large corporations and individuals that wishes to pursue personal tax avoidance objectives. For such characteristics, which make the Exempt Company a very flexible and simple structure, it is commonly used in tax haven jurisdictions.

1.6.7 Special Purpose Vehicle (SPV)

A Special Purpose Vehicle (SPV), also referred to as Special Purpose Entity (SPE), is a legal entity established by a firm, which is called “sponsor”, in order to carry on some restricted activities or achieve specific purposes.

The characteristic of such entity is that its operations are strictly limited to the goals for which it was established, and it cannot make any substantial decision; the SPV is governed by a regulation established in advance that circumscribe its working range. The intrinsic nature of SPVs make them assume the appearance of real companies, for the fact they are legal entities but, in reality, their business decisions are controlled by the sponsor, so that they cannot make any economic decision. Only financing is done in SPVs, they have no employees, no physical location and they cannot go bankrupt: they are a sort of robot firms created to serve specific purposes (Gorton, Souleles 2007: 550).

SPVs were not specifically created to be incorporated in tax havens and serve as vehicles for realizing profit shifting and tax avoidance, they are legal entities that can serve for securitization[20] and for other legitimate business purposes, such as raising capital for the sponsor firms and for reducing the risk for a certain class of assets by transferring them to the SPV, and in this way legally separate them from the sponsor's creditors.

The SPV serves these purposes because, as a matter of design, they cannot go

20 As Schwarcz explains, in securitization, a company partly "deconstructs" itself by separating certain types of highly liquid assets from the risk generally associated with the company. The company can then use these assets to raise funds in the capital markets at a lower cost than if the company, with its associated risks, could have raised the funds directly by issuing more debt or equity (Schwarcz 1994: 134).

bankrupt (Feng, Gramlich, Gupta 2009), and the assets transferred by the sponsor firm to the SPV are for this reason separated by the risk associated with the sponsor. The transfer of assets from the sponsor to the SPV is in the form of a true sale, that is, the SPV is the purchaser of the assets from the sponsor; once the purchase has been made, the assets are owned by the SPV but the cashflows generated by those assets are still managed by the sponsor firm (Klee, Butler 2002), because, as mentioned above, it is not allowed to make any substantial business decision.

The SPV is a separate legal entity, and for this reason the assets transferred to it are not included in the sponsor's financial statement (Schwarcz 1994: 142): this means that, once the sponsor firm transfers the assets to the SPV, they appear as part of the SPV assets and no more part of the sponsor's. Consequently, the income generated by those assets are separated from the sponsor firm's income, allowing the sponsor to shift the taxable part of income from high-tax jurisdictions to low-tax ones.

Hence, this is a way to allocate tax benefits to the entity which can more efficiently report them, that is, the SPV incorporated in the low-taxed jurisdiction, for exemple a tax haven. For this purpose, the SPV can take the form of a synthetic lease,[21] which is not recorded as an asset in the financial statement of the sponsor firm and so it is not subjected to taxation in the home country.

By its nature, SPV is created to ring-fence financial risks and may not appear on the balance sheet of the sponsor (Lane, Milesi-Ferretti 2011: 4). Hence, their use is motivated by economic reasons, tax incentives and financial reporting motivations (Feng, Gramlich, Gupta 2009). The SPV is a very flexible structure and can take several legal forms: corporation, trust, partnership, limited liability company or limited liability partnership.

Going into detail, it is possibile to identify various types of SPEs associated with diversified tax purposed: the most frequent is the use of SPV as intermediate holding, which permits the avoidance of withholding taxes on intra-group dividends, the avoidance of capital gains tax and home country tax on foreign dividend income, and

21 A synthetic lease is structured in a way so that it is not recorder as a liability on the balance sheet, instead, it is considered to be an expense on the income statement. This type of lease allows a company to control a certain asset without being required to show it as an asset on the financial statement (source: http://www.investopedia.com/terms/s/syntheticlease.asp).

the protection of the investment. SPV that serve as intra-group loan conduit permits the avoidance of withholding tax on intra-group interest and the host country corporate tax; whereas the establishment of a SPV as fund raising vehicle permits the avoidance of withholding taxes on interest to external creditors. SPVs established as intra-group or mixed financing companies are combinations of these purposes (Weyzig 2013: 11).

SPVs are not structures specifically created for tax avoidance purposes, they can be utilized for legitimate business operations and for the optimal allocation of risks, serving also as a method for raising funds in the capital market; even so, their features efficiently support also illegal intention. If the characteristics of SPVs are exploited for sheltering taxable income in low-taxed jurisdictions, they efficiently become a strategy that can be used by multinational firms in their tax avoidance operations run in tax havens.

SPVs are not only used for tax purposes, but are also established offshore to serve as the core of Variable Interest Entity[22] (VIE) structures, which play a relevant role in China as a strategy for circumventing restrictions on foreign investments imposed by Chinese laws in some industry sectors.[23]

The VIE structure is formed by three elements: a SPV established offshore, usually in haven jurisdictions with a favorable tax treatment, that serve as holding company and typically do not undertake substantial activities; an operating business entity located in China and, between them, there is a wholly foreign-owned company (Wilson 2014: 5).

VIEs are largely used in China in order to circumvent the restrictions imposed by the government on FDI, in particular with regard to some sectors, such as the Internet sector, in which foreign investments are prohibited, as well as foreign ownership in companies domiciliated in China (Johnson 2015: 252).

22 In technical terms, a VIE is a legal entity in which an investor holds a controlling interest, despite not having a majority of its share ownership (source: http://www.investopedia.com/terms/v/variable-interest-entity.asp, accessed 13/02/2017).

23 VIEs and their use within China will be extensively discussed in in the following chapter.

1.6.8 Other Offshore Structures and Financial Institutions

There is a huge proliferation of structures that can be used in haven jurisdictions. One of the methods used in order to disguise assets and ownership in tax havens is the establishment of foundations.

The foundation is an arrangement similar to a trust, that has the characteristic of presenting a legal existence separated from its settlor or the person who manages it, and for this reason can be considered similar to a limited liability company. Moreover, it is not taxable and, as the other offshore structures are, is designated to be obscure, and as trusts are, in foundations owners or shareholders are non-present. They are established in order to manage assets and income designed for a specific purpose (Palan, Murphy, Chavagneux 2013: 93). Mutual and hedge funds are also commonly used in offshore jurisdictions.

Moreover, financial institutions are commonly present in tax havens, such as banks or insurance companies. The main reason for their presence there is essentially the same that motivates the creation of other structures managed by non-resident corporation: the exploitation of favorable regulations and the various forms of benefit that they can find in tax havens.

Throughout the years, there has been an enormous proliferation of banks in tax havens, primarily motivated by tax advantages such as the absence of capital tax or withholding tax[24] on dividends or interests, no tax on transfers, no corporation tax or capital gain tax and no exchange control; in addition, there is also a lightly regulated environment and light supervision, and less stringent reporting requirements and trading restrictions (IMF 2002).

The banks present in tax havens have different underlying nature. They can be merely "empty shell" banks, which have minimal or no real presence in the territory and are involved in illegal and criminal activities; a second type is represented by

24 Withholding tax is a tax on interest and dividends payable by a company to recipients in another country; as the domestic country cannot tax individuals in foreign countries, a withholding tax ensures the government gains at least some revenue from such payments (Simon 1998: 169). In other words, it is a tax levied on income, in the form of interest and dividends, from securities owned by a nonresident, as well as other income paid to nonresidents of a country (source: http://www.investopedia.com/terms/w/withholdingtax.asp, accessed 24/01/2017).

subsidiaries of large banks located in foreign countries, which establish one or more subsidiaries in the haven jurisdiction essentially to evade taxes or other regulations, or in order to provide offshore fund administration services[25] (IMF 2002).

Also, they are used for "off balance sheet"[26] activities, as an example, they are used as conduits and structured investment vehicles[27] in securitization operations: they are established offshore and employed to purchase assets in the domestic country (Lane, Milesi-Ferretti 2011: 4).

Multinationals can take advantage from establishing a bank in a tax haven, by using it to finance their own activities in their home countries. Apart from these two types, which are substantially used for illegal purposes, the banks present in tax havens can also be true subsidiaries established in offshore location, that operate as true banks without any tax avoidance or illegal objective (Palan, Murphy, Chavagneux 2013: 95).

Moreover, in tax havens are located also insurance companies. In particular, there is a widespread use of the so called captive insurance companies[28] established by commercial companies located in foreign countries. Captives were originally created to allow corporations to set up subsidiaries in order to insure their company's own risk.[29]

These kinds of companies are created by large corporations for minimizing risks and also for financial benefits, such as the minimization of taxes. A captive insurance company is a sort of self-insurance for corporations, because the parent company pays a premium to its captive insurance company located in haven jurisdictions, with the purpose of deducting that amount of money from its taxable income. In this way, the captive insurance company acts both as insurance against risk for its parent company,

25 The services provided include fully integrated global custody, fund accounting and administration, and transfer agent services (IMF 2002).

26 The term "off balance sheet" refers to assets or liabilities that do not appear on a company's balance sheet but that are nonetheless effectively assets or liabilities of the company (source: http://www.investopedia.com/terms/o/off-balance-sheet-obs.asp, accessed 25/01/2017).

27 A structured investment vehicle is a pool of investment assets that attempts to profit from credit spreads between short-term debt and long-term structured finance products such as asset-backed securities; it is less regulated than other investment pools, and is typically held off the balance sheet by large financial institutions (source: http://www.investopedia.com/terms/s/structured-investment-vehicle.asp, accessed 25/01/2017)

28 A captive is an insurance company created and wholly owned by one or more non-insurance companies to insure the risks of its owner or owners. Captive insurance companies are essentially a form of self-insurance whereby the insurer is wholly owned by the insured (source: http://www.naic.org/cipr_topics/topic_captives.htm, accessed 25/01/2017).

29 Source: http://www.naic.org/store/free/SPV-OP-13-ELS.pdf, accessed 2/02/2017

and also as a tax minimizing instrument.

The insurance companies established in tax havens may also be subsidiaries of insurance companies in foreign countries, that are created in order to reinsure certain risks underwritten by the parent company and to reduce the overall reserve and capital requirements. The advantages of establishing insurance subsidiaries in those jurisdictions include the favorable regime concerning income tax, withholding tax and capital tax, and also the low level of reserve and capital standards required (IMF 2002).

1.7 Data

Given the nature of secrecy of tax havens and the opacity surrounding all the operations and transactions undertaken there, it is difficult to have precise figures regarding the amount of wealth hidden there and an exact quantitative evaluation of the capital flows channeled through tax havens and OFCs.

Statistics that are provided regarding assets managed in tax havens are confusing and imprecise, and methods for gathering data are not standardized, consequently, the results about proportion of assets routed through tax havens very much. Nevertheless, various institutions and scholars tried to gather information and data, and provide reliable estimate of the impact of this phenomenon on the global economy (Palan, Murphy, Chavagneux 2013: 47).

It is relevant to try to have an overall view of how this phenomenon evolved throughout the years, and to understand which is the impact that it had on the world economy from different points of view: in terms of amount of wealth held offshore, pattern of investments, and structures established there.

A study considering the period 1970-2007 estimated that the unregistered private capital originated in developing countries and invested offshore reached, as a minimum, between $150 billion and $200 billion per year; this leads to the assessment that offshore wealth accumulated by developing countries was approximatively $6.2 trillion by 2007. These figures accounted only for the wealth coming from developing countries, which is around 25-30% of the total amount of offshore wealth. This result implies that the overall amount was much higher than that value (Henry 2012: 19).

Other estimations are based on data provided to the Bank of International Settlements[30] (BIS), which include data on international assets, such as bank loans and obligations, and liabilities, such as deposits and shares. Those data showed that the proportion of bank's cross-border assets and liabilities in OFCs reached 65% in the late 1980s, but after that peak declined, and reached 51% in 2007 (Palan, Murphy, Chavagneux 2013: 51).

The BIS also evaluated that, by the end of 2003, the external position of offshore banks in terms of assets was around $1.9 trillion, while the total bank assets were $16 trillion; with regard to external loans, the estimation was around $1.5 trillion, that correspond to the 13% of the world cross-border bank claims, that was $11.9 trillion.

Considering securities, OFCs managed assets for a value that reached around $400 billion that, compared to the total assets managed worldwide (about $12 trillion), are a relatively modest percentage (Zoromè 2007: 25).

Other sets of data collected by the BIS showed that by the end of 2007, offshore banks on average held around 47% of total cross-border deposits and about 43% of all cross-border loans from banks in other tax havens (Palan, Murphy, Chavagneux 2013: 51).

By that date, it was estimated that between $5 trillion and $7 trillion were located in tax havens, and that half of the global stock of money was routed through OFCs; according to the data provided to the BIS, all the banks registered in Cayman Islands managed around $1.5 trillion in deposits.

Moreover, the registered mutual funds in Luxembourg reached $2.3 trillion of assets, whereas Swiss banks around $4 trillion (Sullivan 2004).

In 2007, the estimation of total cross-border lending was nearly $24.5 trillion, and this means that, if considering the fact that tax havens are supposed to manage half of the world's stock of money, the wealth routed through tax havens and OFCs can be estimated as around $12.2 trillion. However, this is an approximate calculation and the

30 The Bank for International Settlements (BIS) was established in 1930, and is the world's oldest international financial organization. It has 60 member central banks, representing countries from around the world. The mission of the BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks. Through its Financial Stability Institute (FSI), the BIS helps to foster an understanding of supervisory standards and practices globally and to assist in their implementation (source: https://www.bis.org/about/index.htm?m=1%7C1, accessed 13/02/2017).

result is overestimate, because the data collected by the BIS for making this calculation considers not only tax havens and OFCs, but also includes the money managed in international financial centers such as London, United States and Tokyo (Palan, Murphy, Chavagneux 2013: 51).

According to other estimates, in 2006 52.3% of the global amount of hedge funds was held within Cayman Islands, BVI, Bermuda and Bahamas, while the 30.1% was held in the United States (Sullivan 2007a). Speaking of numbers, according to an average between different methods of calculation used by Sullivan, at the end of 2006 the hedge fund assets held in the Caribbean Islands was, respectively, $24.352 million in Bahamas, $85.675 million in Bermuda, $150.559 million in BVI, $525.503 million in Cayman Islands, for a total that reached $743.296 million (Sullivan 2007b).

In some cases, some information is provided regarding the number of entities established in tax havens; it is not possible to assess whether the data are exhaustive and reliable, but this allows to have an idea of the extent of the business conducted there.

According to estimates regarding IBCs, in 2007 in the BVI there were approximately 802.000 IBCs, while the IBCs established in Cayman Islands, Hong Kong, Panama, and Bahamas were respectively around 62.000, 500.000, 370.000 and 115.000. There were 450 banks in Cayman Islands, 82 in Singapore, 34 in Panama, 139 in Bahamas and 9 in the BVI. The number of captive insurance companies was approximately 740 in Cayman Islands and 402 in the BVI (Palan, Murphy, Chavagneux 2013: 58).

By the end of 2008, the number of companies incorporated in the BVI, including both BVI Business Companies and IBCs[31], was estimated at 414,620 (Caruana-Galizia, Caruana-Galizia 2016: 4). In 2008, it was also estimated that were registered 8,082 Samoa International Companies; 1,257 Cayman Islands International Companies, 989 Cayman Islands Asset Protection Trusts, 620 Cayman Exempts; 1,136 Hong Kong Domestic Companies; 696 Singapore Domestic Companies; 413 Labuan Offshore Companies; 386 Seychelles IBCs (Caruana-Galizia, Caruana-Galizia 2016: 10).

31 The BVI Business Companies Act came into force in 2005, replacing the existing BVI IBCs Act, partly as a result of external pressure. Under the previous IBCs Act, companies were exempt from taxation in the BVI, whereas under the new Act they may be subject to taxation, but only on the transfer of real estate and assets in a BVI company owning real estate within the territory of the Islands (Caruana-Galizia, Caruana-Galizia 2016: 11).

Attempts in estimating the number of assets held offshore by individuals were also made, but such data are even more laborious to extrapolate because the information available are not detailed and, for this reason, is difficult to estimate the portion of wealth owned by individuals within the total amount held offshore.

Murphy provided an estimation using three sets of available data, coming from the BIS and other international reports; the results showed that in 2005 the total wealth of individuals, considering North America, Europe, Middle East and Asia and Latin America, reached around $38 trillion, of which the probable amount held in tax havens and OFCs on the whole was around $9 trillion. This estimation does not take into account other kind of tangible assets or real estate, nor include other intangible assets such as royalties and licensing fees; the values of this kind of wealth is even harder to assess, but evaluating it using a minimal, it can be estimated around $2 trillion. As a result, the total amount of wealth owned by individuals held in tax havens and OFCs can be assessed to be approximatively between $11 trillion and $12 trillion (Murphy 2006).

However, further studies considered these figures inaccurate, giving a considerable underestimation of the impact of offshore activities: the revised calculations estimated the amount of private offshore financial assets not $9.5 trillion by 2004, but ranging between $12.1 trillion and $20 trillion. Afterwards, between 2004 and 2007, the financial wealth held offshore registered a rapid growth, reaching an amount between $22 trillion to $33 trillion (Henry 2012: 36).

Also Sullivan tried to estimate the proportion of assets owned by individuals and held in tax havens, and that, as a result, are assets not subject to taxation in the countries of residence. By the end of 2006, the non-residents' assets reached $262.8 billion in the form of hedge funds the Caribbean Islands of Cayman Islands, British Virgin Islands, Bahamas and Bermuda; $607.4 billion in Switzerland, $491.6 billion in Jersey, that reached $500 billion in the first half of 2007; $293.1 billion in Guernsey, that reached $300 billion in the first half of 2007; and $150.5 billion in the Isle of Man, which reached $200 billion by the end of 2007 (Sullivan 2007b).

In 2006, the total amount of cross-border capital flows derived from illicit business operations and directed towards tax havens and OFCs was estimated between

$1 and $1,6 trillion each year; moreover, it was estimated that between 2002 and 2006 the increase was on average 18.8% every year (Kar, Cartwright-Smith 2008).

In particular, an approximative estimate concerning that period showed that cross-border flows due mispricing arrangements was between $200 billion and $250 billion annually; those due to manipulation of transfer prices between $300 billion and $500 billion per year, and illicit cross-border cashflows related to fake transactions, every year, was between $200 billion and $250 billion (Baker 2005).

In 2008 the global offshore private wealth owned by individuals was estimated as approximatively $8 trillion by a financial consultant, the Oliver Wyman Group[32], whereas the calculation for the same year made in 2009 by Boston Consulting Group was $7.2 trillion of liquid offshore assets, which decreased to $6.7 trillion by 2008. However, these figures were inaccurate, as did not take into consideration the portion of wealth held in Africa and also did not include non-financial wealth held offshore in the form of trusts and foundations, which indeed represent a considerable proportion (Henry 2012: 17).

Further calculations assessed the global private financial wealth held in tax havens and OFCs, by 2010, as ranging between a minimum of $21 trillion to a maximum of $32 trillion; also, this estimation included only financial wealth, and did not take into consideration real estate and other non-financial assets which are held offshore through various intermediaries.

It was evaluated that private wealth accumulated offshore since the 1970s, and unrecorded, was between $7.3 trillion and $9.3 trillion in 2010, coming from developed countries all around the world; the same countries in 2010 had an aggregate external debt of minus $2.8 trillion and such data lead to the result of an amount ranging between $10.1 trillion and $13.1 trillion of private unrecorded offshore wealth (Henry 2012: 6).

Global private banks play a crucial role in this phenomenon: apparently, according to analysis including the 50-major international private banks, by 2010 they managed more than $12.1 trillion in offshore invested assets from private clients. This first figure

32 Oliver Wyman (2008), *The Future of Private Banking: A Wealth of Opportunity?*, http://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2008/OW+Report+-+The+Future+of+Private+Banking.pdf, accessed 2/02/2017.

includes only trusts and foundations, but the amount reach the previously mentioned total of $21 to $32 trillion if including within it also smaller banks, insurance companies, non-bank intermediaries such as hedge funds, and self-managed funds (Henry 2012: 8).

As a term of comparison, in order to assess how fast is this phenomenon growing, in 2005 those banks managed around $12.06 trillion of private cross-border financial wealth; this comparison allows to estimate an average growth of almost 16% per year (Henry 2012: 33).

In terms of erosion of the tax bases of foreign countries, assessing the global amount of offshore financial wealth at $21 trillion, this unrecorded wealth held offshore might have generated in the domestic countries approximatively $189 billion of tax revenues per year (Henry 2012: 42).

According to the estimation made by Zucman, today around 8% of the global financial wealth is held in tax havens; he also estimated that 55% of the foreign profits of U.S. Firms is hidden in such jurisdictions (Zucman 2015: 4).

At the beginning of 2014, according to organizations such as the Federal Reserve (United States) or the Office for National Statistics (UK) the global financial wealth is estimated to be around $95.5 trillion. Thus, taking into consideration the calculation provided by Zucman,[33] who estimated that the wealth concealed in tax havens is around 8% of the global amount, in haven jurisdiction spread all over the world is held around $7.6 trillion (Zucman 2015: 35).

The limit that can be observed in this estimation is that the method takes into consideration only financial securities but, in fact, excludes other types of wealth, such as regular bank deposits, also, it does not take into account life insurance policies, in particular stocks or bonds in the form of unit-linked life insurance contracts[34], which are

33 The method followed by Zucman to provide such result started from the observation of the world balance sheet, on which are recorded more liabilities than assets. This is the result of the investments made in tax havens, which result as liabilities in the investors' home country's international investment position, but do not result as assets anywhere, because such money is invested offshore with the objective to hide it from tax authorities in domestic countries. Thus, on a global level anomalies arises, because are recorded more liabilities than assets: all the financial securities held outside countries of residence are registered as liabilities but not as assets. Zucman used these anomalies in the international investment position of countries as starting point for the evaluation of the amount of wealth hidden in tax havens globally (Zucman 2015).

34 It is a product offered by insurance companies that, unlike a pure insurance policy, gives investors

legally owned by insurers[35]; also, non-financial wealth, such as real estate or other material properties, is not included (Zucman 2015: 44). Consequently, the resulting estimation is a minimal, and does not provide an exact amount of the wealth concealed in tax havens all over the world. As mentioned above, this is also due to the secrecy and opacity that characterize such operation, and a big proportion of them is not easily found in published statistics. Nevertheless, the analysis provided by Zucman is a valuable and reliable assessment of the phenomenon.

It is relevant to stress also the proportion of Foreign Direct Investment (FDI) that is invested or at lass pass through tax havens: according to available data, today nearly 30% of FDI occur there (UNCTAD 2015: 188). According to the definition provided by the OECD, FDI are defined as:

> an incorporated or non-incorporated enterprise in which a foreign investor owns 10% or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise.[36]

This denomination refers to the holding of shares, both active of passive, in foreign enterprises. FDI is defined by the OECD as cross-border investment made by an entity located in one economy with the objective of obtaining a lasting interest in an enterprise resident in another economy (Wilson 2014: 207): the implication of this definition is that the term FDI represents ownership structures incorporated abroad.

As a result, this explain the proportion of FDI directed towards tax havens: multinational companies use the subsidiaries established in haven jurisdictions in order to invest in foreign countries. Multinationals do not wish to invest directly there, but they route their investment through tax havens, only for redirecting them towards the real final destination elsewhere (Palan, Murphy, Chavagneux 2013: 53). As explained before, one of the primary motivation that attract foreign investment in havens

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both insurance and investment under a single integrated plan.

35 For the fact that they are legally owned by insurers, they result as assets in the balance sheet of insurance companies, and for this reason they do not cause the anomalies in the financial position of country that, as previously explained, constitute the starting point of the calculation method applied by Zucman. (Zucman 2015: 44).

36 OECD (1999), *OECD Benchmark Definition of Foreign Direct Investment*, Third Edition, http://www.keepeek.com/Digital-Asset-Management/oecd/finance-and-investment/oecd-benchmark-definition-of-foreign-direct-investment_9789264064805-en#.WKRbKFXhDIU#page1, p. 8.

jurisdiction is the favorable level of taxation, and this is true also with regard to FDI, which take advantage of tax benefits there.

With regard to FDI passing through tax havens before being redirected elsewhere, it is important to notice the situation existing in China, where Hong Kong and the BVI are the major sources of its inward FDI. The BVI, together with Hong Kong and Cayman Islands, are hubs that receive investments of Chinese capital and then redirect them again towards China as FDI originating in those foreign jurisdictions. In other words, a large part of inward FDI in China is composed of Chinese capital invested offshore, and then re-invested inside the country, in a process called round-tripping.

BVI and Cayman Islands, together with Hong Kong, are commonly recognized as the main centers of Chinese offshore activity (Haberly, Wójcik 2015: 25). These offshore locations are both major recipients of global FDI and major sources of FDI into China (Wilson 2014: 206).

According to the data provided by the Ministry of Commerce of China, the 86% of capital invested within the country originated by tax havens all over the world; the biggest proportion came from Hong Kong and BVI, followed by Japan, South Korea, Singapore, United States, Cayman Islands, Samoa, Taiwan and Mauritius (Palan, Murphy, Chavagneux 2013: 57).

By the half of 2011 the estimation regarding the global wealth reached $231 trillion, and this value was inclusive of both financial and non-financial assets; the inclusion of the latter made this calculation more comprehensive that other previous estimations, which often neglected it.[37]

The role of offshore hubs has been extremely relevant in the international investment structure of multinational corporations: in fact, in 2012 the 30% of the global amount of international corporate investments, that was estimated at $21 trillion, was routed through offshore jurisdictions; this 30% accounts for approximatively $6.5 trillion. Furthermore, the 28% of the total amount of cross-border corporate investments is invested into offshore jurisdictions using intermediary entities (UNCTAD 2015: 189). Such entities, as discussed previously, sometimes operate offshore on behalf of parent

37 Credit Suisse Research Institute (2011), *Global Wealth Databook 2011*, https://publications.credit-suisse.com/tasks/render/file/index.cfm?fileid=88E47246-83E8-EB92-9D54129E76CA737B, accessed 4/02/2017.

companies located in high-tax jurisdictions, providing management, asset administration or financial services, but more often they are purely letterbox companies which do not undertake substantial economic activities. Between 2000 and 2010, the average share of investment flows channeled through tax havens and OFCs increased from 19% to 27% (UNCTAD 2015: 190).

With regard to offshore jurisdictions in the Caribbean area, the investment flows peaked in 2013; in 2014 registered a slowing down, with an approximate decrease of 45% compared to the previous year, but was still consistent. In 2015 the level reached again the average of 2008-2012, and was around $72 billion.

Of the jurisdiction in this area, the major are Cayman Islands and BVI, which alone account for a greatest proportion of the total. In these two jurisdictions, between 2010 and 2014, the 65% of investment flows originated from Hong Kong, Russian Federation and China; this was an inversion in the traditional pattern of investment flows there, which before was dominated by investments from multinational groups located in developed economies such as the United States (UNCTAD 2016: 20).

In particular, in 2014 the income booked in foreign affiliates registered considerable levels compared to the GDP of those small territories: in the Cayman Islands was estimated $30 billion, which accounted for 874.9% of the domestic GDP; in Bermuda was $44 billion, that is 779.4% of the domestic GDP; in Hong Kong it was $23 billion, accounting fo 8% of the GDP; in Netherlands $155 billion, 17.6% relative to GDP; in Luxembourg $74 billion, 114.4% of the GDP; in Switzerland $62 billion, that is 8.9% of the GDP; in Singapore $57 billion, 18.6% of the GDP (UNCTAD 2016: 22).

1.8 Counteraction

The proliferation of tax havens and harmful preferential tax regimes in the last decades, and their increasing exploitation by multinational corporations and individuals, are a growing concern for international organizations and authorities.

As mentioned before, the spread of tax havens and the offshore activity began in a period raging between the late 1960s and the 1980s, and registered a remarkable

escalation in the following years. The globalization of national economies and the integration of the global economy increased the potential spillover effects that one country's economy and policies may have on other countries (Weiner, Mault 1998: 601).

Since the very beginning of the phenomenon, it was clear that a sort of counteraction was necessary in order to discourage large corporations and individuals to engage in such harmful practices, since the harm they caused to countries all over the world was enormous.

One of the main organizations engaged in the fight against tax havens and harmful tax competition is the Organization for Economic Cooperation and Development (OECD). The OECD's Committee on Fiscal Affairs launched the project on harmful tax competition, and the OECD Council of Ministers issued a Report on April 29, 1998, entitled "Harmful tax competition: an emerging global issue" (Weiner, Mault 1998: 602), that was the first extensive action addressing such issue.

The aim of the Report was, first, to provide clear directions in the identification of harmful practices, both in the form of tax havens and harmful preferential tax regimes, and then give recommendations to OECD member and non-member countries, with the purpose of discouraging and eliminating such practices. The Report appeals for collaboration in the fight against tax havens, and has both the purpose of discouraging countries in engaging in such practices, and persuading countries that have already implemented such regimes to eliminate them.

Also, the Report stresses the need for an international cooperation and for a coordinated action at a worldwide level, because, if such extensive collaboration is missing, countries have no incentives in curbing harmful tax practices: given the nature of financial flows, which is intangible and geographically mobile, the elimination of harmful preferential tax regimes in only few countries will simply lead to the flow of those financial activities elsewhere (OECD 1998: 38).

This is the reason why a collaboration on a large-scaleis necessary and the commitment of every country to contrast and eliminate such regimes. However, provided that countries abide by international standards, the Report stressed their right to choose and establish their own domestic tax policies (Weiner, Mault 1998: 603).

The recommendations given by the OECD concern the domestic legislation of

countries, the international tax treaties and the need of an intensified international cooperation. In particular, those recommendations were aimed at ensuring that tax treaties do not unintentionally create loopholes which can be exploited for tax evasions,[38] and enhancing the effectiveness of exchange of information across countries for tax purposes; moreover, they ask for a collaboration of countries also with regard to the implementation in the domestic legislation of effective measures that prevent and counteract harmful practices (OECD 1998: 39).

One of the main concern of the OECD was the improvement of the exchange of information between countries, because this can be considered one of the basic factors that favor tax avoidance: if countries do not effectively exchange relevant information for tax purposes, this reinforce the obscurity surrounding tax evasion practices, and reduce the effectiveness of counteract measures. The access to bank information and the exchange of such information is fundamental in order to trace back to the real owners of capital held in other countries and to impede the possibility of hiding wealth in tax havens and other financial center for escaping taxation in domestic countries. This is the basic requirement and the necessary starting point for any action aimed at counteracting tax evasion and harmful tax practices.

In general terms, the Report wishes to encourage countries to refrain from adopting new measures or strengthening existing ones, to review and adapt existing provisions, and to remove the existing harmful practices of their regimes (Weiner, Mault 1998: 606). The guidelines set in this Report represent in a way the basic foundation of the action against tax havens and harmful preferential tax regimes, and the starting point from which following actions originated.

As a result of the Report issued in 1998, the OECD established the Forum on Harmful Tax Competition, which further emphasized the need for international cooperation in preventing the erosion of countries' tax base as a result of harmful preferential tax regimes and harmful practices.

38 As an example, the so called “treaty shopping” which has the purpose of exploiting in a favorable way the interactions among tax conventions, for tax minimization objectives. It can be mentioned the improper use of Double Tax Conventions, which are created in order to avoid the double taxation on the same income in two different countries: they are used by multinational groups to evade taxes both in their country of residence and in the country in which the profit arose because, as a result of the improper exploitation of these provisions, the income from cross-border activities go untaxed anywhere. See also paragraph 1.6.

The Forum carried on an analysis and evaluation of existing regimes, taking into consideration both OECD member and non-member countries, with the purpose of assessing the existence of harmful preferential tax regimes and identifying which countries are in fact tax havens. As a result, 49 countries were classified as tax havens, and they were divided into three categories: compliant, non-compliant, and largely compliant countries, according to their commitment to collaborate with the OECD and adapt to international standards (IMF 2002).

After the Code of Conduct issued on December 1997, which regulated business taxation and provided a package of measures to contrast harmful tax competition (Weiner, Mault 1998: 607), the most relevant international tax policy issued by the European Union (EU) was the Tax and Savings Directive, issued in 2005. Its purpose was to identify assets owned by EU individuals in jurisdictions that agreed to cooperate;[39] going into detail, it introduced a 15% withholding tax on the interest income earned by entities in OFCs which have, as ultimate owner, an EU-resident individual.

The limit of this Directive is that it can be applied only in cooperative jurisdictions, and only in the case that the ownership can be directly attributed to an EU resident. As a consequence, it can be easily bypassed by transferring the ownership of the offshore entity to a non-resident or to a sham company, or by incorporating the entity in a jurisdiction which did not agree to cooperate (Caruana-Galizia, Caruana-Galizia 2016). Considering these shortcomings, this Directive can be considered only partially effective in the fight against tax evasion.

Issues concerning transparency and information exchange with regard to tax matters, and the need of keeping track of multinationals' cross-border activities, also come from the G20[40] summit held in London in 2009. The G20 leaders also stressed the

39 Cooperating OFCs are: Andorra, Anguilla, Aruba, BVI, Cayman Islands, Guernsey, Isle of Man, Jersey, Liechtenstein, Monaco, Montserrat, Netherlands Antilles, San Marino, Switzerland, Turks and Caicos Islands (Caruana-Galizia, Caruana-Galizia 2016: 6).

40 The G20 is an international forum for the governments and central bank governors from 20 major economies: is composed by 19 member countries plus the European Union. It comprises a mix of the world's largest advanced and emerging economies, which are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union. It was founded in 1999 with the aim of studying, reviewing, and promoting high-level discussion of policy issues pertaining to the promotion of international financial stability. The work of G20 members is

importance of preventing illicit financial activities that threaten the global financial system by tackling the lack of transparency and the malfunction of the exchange of banking information. They also reaffirmed the support to existing initiatives against money laundering, terrorism financing and hidden financial wealth (Helleiner, Pagliari 2009: 283), all issues that are directly related to the existence of tax havens and OFCs.

In that occasion, G20 leaders even decreed the "end of banking secrecy" but, after that promising statement, it seems that the money held by individuals in tax havens around the world had increased close to 25% (Zucman 2015: 4).

OECD also addressed the basic problem arising from the existence of gaps and loopholes between tax systems of different countries, which allows practices such as the treaty shopping, that is the Base Erosion and Profit Shifting (BEPS). The existing treaties between states have the purpose of allocate the taxation between the country of residence and the country in which the income is earned, in order to avoid the double taxation of income generated by cross-border activities; these treaties, as already mentioned, lead to the practice of treaty shopping by multinational corporations.

In order to prevent such "double non-taxation" (OECD 2013: 13), in 2013 the OECD issued an Action Plan on Base Erosion and Profit Shifting. The action promoted by OECD has as objective the revision of the international standards concerning corporate income taxation, in order to make them coherent on an international level and correcting the existing gaps; furthermore, the bilateral treaties aimed at preventing double taxation must be revised in order to avoid the opposite effect of double non-taxation, and it is stressed the importance of further transparency and collaboration between countries, since the availability of timely and comprehensive information is absolutely relevant for the success of the goals of the action plan.

Going into detail, the specific purposes of the OECD Action Plan include: address the tax challenges of the digital economy; neutralize the effects of hybrid mismatch

supported by several international organizations that provide policy advices; such organizations include the Financial Stability Board (FSB), the International Labor Organization (ILO), the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), the United Nations (UN), the World Bank and the World Trade Organization (WTO) (source: https://en.wikipedia.org/wiki/G20, accessed 13/02/2017).

arrangements[41] and arbitrage, strengthen Controlled Foreign Companies[42] (CFC) rules; limit base erosion via interest deductions and other financial payments; counteract harmful tax practices more effectively, taking into account transparency and substance; prevent treaty abuse; prevent the artificial avoidance of Permanent Establishment (PE) status; assure that transfer pricing outcomes are in line with value creation, with regard to intangibles, risks and capital and other high-risk transactions; establish methodologies to collect and analyze data on BEPS and the actions to address it; require taxpayers to disclose their aggressive tax planning arrangements;[43] re-examine transfer pricing documentation; make dispute resolution mechanisms more effective; and, finally develop a multilateral instrument (OECD 2013).

The matter of international exchange of information was further addressed by OECD in the document issued in 2014 entitled "Standard for Automatic Exchange of Financial Account Information in Tax Matters", which include two main sections: the first, Common Reporting Standard, includes all the provisions regarding the reporting and the effective exchange of information between countries; the second, Model Competent Authority Agreement, provides the model that can be used by countries in the implementation of bilateral agreements concerning the information exchange (Carbone, Bosco, Petese 2015: 58).

Another relevant legislation was enacted by the 111th United States Congress[44] in 2010, which is the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147),

41 The so-called hybrid mismatch arrangements have the result of double non-taxation or the payment of unduly low taxes, as a result of the existing gaps in the international corporate taxation system (Jones, Temouri 2016: 238).

42 A controlled foreign company (CFC) is a corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners. A CFC is advantageous for companies when the cost of setting up a business, foreign branches or partnerships in a foreign country is lower even after the tax implications. Controlled foreign company laws work parallel to tax treaties to dictate how taxpayers declare their foreign earnings, and was created to help prevent tax evasion, which was done by setting up offshore companies in jurisdictions with little or no tax (source: http://www.investopedia.com/terms/c/cfc.asp, accessed 25/02/2017).

43 Aggressive tax planning arrangements often have some legal basis, in a very technical sense, but they are strategies that "aggressively" push the limit: in general, such arrangements are made for the primary purpose of avoiding the payment of the required taxes, and thus could result in a violation of the law.

44 It was the meeting of the legislative branch of the United States federal government, composed of the Senate and the House of Representatives. It began during the last few weeks of the George W. Bush administration, with the remainder spanning the first two years of the Barack Obama administration. The 111th Congress lasted from January 3, 2009, until January 3, 2011 (source: https://ballotpedia.org/111th_United_States_Congress, accessed 4/02/2017).

that includes several relevant provisions against tax evasion. The most prominent one, included in such Act, is the Foreign Account Tax Compliance Act (FATCA), that entered into force in the United States on March 2010. FACTA imposes to foreign financial institutions, such as banks or other financial institutions, to report to American authorities the existence of financial movements attributable to American individuals, and to timely disclose any relevant information that can be used in order to detect any tax avoidance. It also addresses American individuals, and requires them to file annually their financial accounts held abroad.

After the implementation of FATCA, on July 2012, it has been defined the "Model Intergovernmental Agreement on Improving Tax Compliance and Implementing FATCA" and the "Intergovernmental Agreement" (IGA), that is a model for bilateral agreements between States (Carbone, Bosco, Petese 2015: 16).

There is a wide range of initiatives aimed at counteracting tax evasion by large corporations and single individuals, eliminating harmful tax practices, for improving exchange of information and extensive collaboration, for enhancing the efficiency of international tax legislations and global financial system by eliminating the existing gaps and loopholes and dissuading practices such as treaty shopping and all other practices of tax avoidance. It is not questionable the great effort employed at a global level.

Nevertheless, even if various kind of measures have already been implemented and others are going to be implemented in the forthcoming future, it seems that this is still not enough for drastically eliminate and wipe out the phenomenon, since it is so deeply-rooted in today's global business practices.

Chapter 2
China and Tax Havens

2.1 Introduction

Tax havens and Offshore Financial Centers (OFCs) play a major role not only in the global economy, but also in China's economic system. Before 1978, under Mao Zedong rule, China adopted a policy of self-reliance, that is, foreign trade were limited and the country did not accept foreign investments within its territory, cutting itself off the world economy (Polack 2015: 2).

After 1978 the situation started changing, as China's economic reforms have promoted its integration with the global economy; since the introduction of the policy of 改革开放 gaige kaifang[45] (reform and opening up) in 1978 and the adoption in 1979 of the first foreign investment law, the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (中华人民共和国中外合资经营企业法 Zhonghua renmin gongheguo zhongwai hezi jingying qiye fa), also called Equity JV Law (EJV Law), China started to attract a significant proportion of FDI (外商直接投资 Waishang zhijie touzi) and in 2003 it even became the first recipient of FDI, overtaking the United States. Also after 2003, China continued to be within the top three FDI recipient (Huang 2009: 187).

In more detail, after China joined the World Trade Organization[46] (WTO, 世界贸易组织 Shijie maoyi zuzhi), according to the statistics provided by the UNCTAD, the amount of FDI within the country increased from $46.9 billion by 2001 up to $60 billion in 2004 and to $72 billion in 2005 and 2006. The FDI inflow registered a constant increase throughout the years: it reached $83.5 billion in 2007, $108.3 billion in 2008, $95 billion in 2009, up to $ 114.7 billion in 2010, $123.9 billion in 2011, $121 billion in 2012, $123.9 billion in 2013, $128.5 billion in 2014 and reached $135.610 billion in 2015. Between 2008 and 2015, Chinese inward FDI accounted for a

45It is the program of economic reforms started in December 1978 by reformists within the Communist Party, led by Deng Xiaoping. Such economic reforms were aimed at introducing market principles (source: https://en.wikipedia.org/wiki/Chinese_economic_reform, accessed 25/02/2017).

46 On December 11, 2001, China officially became WTO's 143rd member.

percentage ranging from a minimum of 7.2% to a maximum of 10.1% of the global FDI flows[47].

After the opening up of its economy in the late 1970s, China started to take part in the global economy and, in addition to a massive inflow of foreign capital within its borders, huge capital outflows also started to run out the country. The volume of outward FDI increased remarkably since 1992, and peaked in recent years; in particular, the annual average growth reached 54.9% from 2002 to 2007 (Cui, Jiang 2010: 751).

According to the data provided by the UNCTAD, from $2,518 billion in 2002, the outward FDI flow reached $5,498 billion in 2004, $12,261 billion in 2006 and $26,506 billion in 2007, and it had a remarkable increase since 2008, when it accounted for $55,907 billion. Since then, the increase remained consistent: in 2009 the outward flow was $56,529 billion, in 2010 $68,811 billion, in 2011 $74,654 billion, and in 2012 $87,804 billion. In 2013 it jumped up to $107,844 billion, and in 2014 and 2015 was $123,120 billion and $127,560 billion respectively. Between 2008 and 2012 the amount of Chinese outward FDI accounted for a percentage ranging from 3,2% to 6,7% of the global flow; from 2013 to 2015, the percentage remained between 8.2% and 9.3%.

Capital inflows directed to China originated from both developed and developing country, and also the outflows of capital coming from China are directed towards both developed and developing countries all over the world; however, it is important to notice that a major proportion of this capital flow is routed through tax havens and offshore financial centers.

The outward investment from China to tax havens and offshore location increased rapidly in recent years and, in particular, it was directed towards one tax haven alone, the Cayman Islands: in 2003, around 28.3% of China's outward investment was directed there, and the percentage reached approximatively 44% in 2006 (Sutherland, Matthews 2009: 2). Another tax haven, the British Virgin Islands (BVI), also received a considerable proportion of Chinese outward investment, even if not as high as the Cayman Islands: by 2005 BVI received more than 10% of Chinese outward investment.

The inward investment directed towards China also originated from the same tax haven, BVI alone, which became the primary source of FDI within China: in 2005, the

47 UNCTAD Statistics, http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx, accessed 27/02/2017.

proportion of investment sourcing from BVI was around 14.9%, which reached 17.8% by 2006. As a source of FDI towards China, Cayman Islands is not as important as BVI, but still account for 3.2% and 3.4% in 2005 and 2006. On the whole, by 2006, Cayman Islands and BVI accounted for 47.5% of the total amount of Chinese outward investment flows (Sutherland, Matthews 2009: 4).

Together with Cayman Islands and BVI, also Hong Kong has played and still plays a relavant role in this process of capital flows: it receives huge amounts of FDI coming from the Mainland, and it is also the source of consistent investment towards it.

It is also possible to notice that, throughout the years, Hong Kong even overcame the other two tax havens, in particular due to the tax benefits and preferential treatment accorded since 2004 under the Closer Economic Partnership Agreement (CEPA, 内地与香港关于建立更紧密经贸关系的安排 Neidi yu xianggang guanyu jianli geng jinmi jingmao guanxi de anpai).[48]

In detail, between 2004 and 2009 the volume of Chinese inward FDI coming from Hong Kong increased by 141%, while the increased registered in FDI coming from BVI and Cayman Islands were respectively 69% and 36%. In general, the outward FDI from Hong Kong also rose sharply: in the same period, it was registered an increase of 1.365%, whereas the outward flows from BVI and Cayman Islands registered and increase of 1.489% and 171% respectively (Wilson 2014: 235). The role that Hong Kong plays in Chinese FDI is various: it receives a high volume of FDI from Mainland that are in a second moment reinvested there as foreign capital, but also function as a conduit through which are channeled indirect FDI towards the Caribbean tax havens (Buckley, Sutherland, Voss, Al-Gohari 2015: 11).

The percentage of Chinese outward investment towards these three location by 2005 accounted for 70% of the total amount (Morck, Yeung, Zhao 2007), and by 2011 was still consistent and registered a little increase up to 74% (Buckley, Sutherland, Voss,

48 CEPA is a bilateral free trade agreement between Hong Kong and Mainland China, which became effective on 1st January 2004; this agreement offers easy market access to local and international companies with qualified Hong Kong based companies, regardless of their nationality and size. Even after the compliance of China with its commitments to WTO, many Hong Kong companies still enjoy significant advantages, because the CEPA still offers them great concessions, and in some sectors such concessions extend beyond China's WTO commitments (source: https://www.henleyglobal.com/residence-hong-kong-cepa/, accessed 5/03/2017). It will be further discussed in the following chapter.

Al-Gohari 2015: 2).

By 2010, China alone accounted for a large proportion of unrecorded cross-border capital flows: considering both the flows originated in the mainland and in Hong Kong, the offshore private wealth of Chinese investors reached $1.2 trillion, of which $743 billion came from mainland China and $125.9 billion from Hong Kong. On the whole, this accounted for 13% of the total of global unrecorded offshore wealth (Henry 2012: 31).

Which are the motivations underlying this distinctive pattern of investment?

The tax minimization purpose is one of the drivers of such routing, because, as explained in the previous chapter, tax havens offer a various range of preferential treatment with regard to taxation and, also, offer a lightly regulated environment and a favorable regulation system, which is particularly appealing for the establishment of shell companies and for the booking of transactions there, in particular for tax minimization or tax avoidance purposes. However, with regard to the Chinese investment flow, it is possibile to identify some other peculiarities, which can be traced back to the characteristics of China's economic, political and legal systems.

The following paragraphs will analyze the motivations underlying this pattern of investment between China and offshore jurisdictions, in particular the Caribbean tax havens of Cayman Islands and BVI and Hong Kong.

2.2 Determinants of China's Use of Tax Havens

As explained in the previous chapter, tax havens and OFCs are jurisdictions which attract foreign capital thanks to several factors: the low or no tax rate they offer to non-resident investors, the wide range of financial services they provide, the lightly regulated environment and the less stringent reporting requirements, and also the secrecy and the anonimity they guarantee to investors. They do not only attract foreign capital for taxation reasons, but they also serve as conduit countries for investment into other countries: they attract FDI within their territory, but often they are not the ultimate destination of such investment, which are channeled through those territories to be then redirected elsewhere in a second moment.

Also, in some cases, those investments are intended to be re-invested at a later time in the domestic market from which they originated, which is the so called process of round-tripping. Chinese subsidiaries in these countries may serve as holding companies for investments elsewhere or, in the case of round-trip investments (往返投资 Wangfan touzi), for investing back into China (Morck, Yeung, Zhao 2007).

The preferential treatment accorded to foreign investors in order to attract FDI into China was one of the incentives for channeling Chinese investment through tax havens and OFCs and then back into China through the process of round-tripping: foreign-invested enterprises were subject to lower tax rates than domestic-invested enterprises, hence, this was an incentive for Chinese enterprises to reconstitute themselves as foreign-invested business. This purpose was achieved by creating offshore holding companies that owned the domestic Chinese subsidiaries; in this way, Chinese capital was moved offshore in order to redirect it back to China in the form of foreign capital (Ning, Sutherland 2012: 170).

The choice of tax havens and OFCs for the incorporation of companies with the purpose of acting as holding companies or listing vehicle is also driven by technical factors, such as the rapidity and the low cost of incorporation: the cost of incorporation of companies, including legal fees and other costs, is under $5.000 in Cayman Islands, BVI and Hong Kong; the time needed for incorporation is between 1 and 3 days for Cayman Islands and BVI, whereas it is between 7 and 21 days in Hong Kong. The preference of such offshore locations, rather than another well-known OFC, Bermuda, is due to these factors: by contrast, the cost of incorporation in Bermuda is nearly $10.000 and it is needed from 14 up to 35 days for its implementation (Greguras 2008: 7). The preference of Chinese investors for the first three locations is evident, as they offer a rapid and low-cost solution for investors that seek to establish shell companies in order to conduct further businesses.

Commonly, tax havens and OFCs are the location of complex trusts and corporate structures, whose ultimate owners adopt in order to hide assets from authorities; by contrast, Chinese offshore structures do not involve complex relationships of partial ownerships structured using several levels. Usually Chinese offshore organizational form is quite linear, even though there are cases in which more complex structures are

involved.

The typical organizational structure implemented by Chinese firms, in its simplest arrangement, provides also an explanation for the pattern of investment to and from the Caribbean tax havens of Cayman Islands and BVI: as mentioned before, Cayman Islands are the main recipient of China's outward investment, while BVI is the main source of the inflows of FDI into China. In fact, a common offshore structure involves an holding company incorporated in the Cayman Islands, which holds a BVI subsidiary that, in turn, holds the Chinese subsidiary; in this way, the Chinese subsidiary is indirectly controlled by the ultimate owner through various levels of ownership. Investments are made in the Cayman Islands holding company, and the Chinese subsidiary is the operating company.

The motivations underlying the process of round-tripping, and the consequent relationship between China and tax havens are various. Apart from the response to the preferential treatment accorded to foreign investment, the routing of Chinese capital through tax havens and offshore jurisdictions can be considered a response to the imperfections of China's capital market,[49] and to other institutional factor which also play a contributing role (Sutherland, El-Gohari, Buckley, Voss 2010: 1).

The literature, in fact, in explaining the determinants of the use of tax havens by China, tends to emphasize factors other than the favorable taxation system that can be found there, where, as explained in the previous chapter, non-resident investors can benefit from low or no tax-rate and other incentives. By channeling capital through offshore jurisdictions Chinese investors can, of course, benefit from the low tax rate and the less regulated environment, but this seems to be considered as a secondary factor.

The choice of investing the capital in tax havens rather than in other high-taxed jurisdictions or other developed country can definitely be attributed to the favorable taxation environment offered by havens jurisdictions, but the choice to invest capital offshore itself, rather than keeping it inside China, is driven by different factors, other than the mere taxation advantages. Chinese FDI flows towards those tax havens involve

49 A capital market is a market that facilitates the buying and selling of financial instruments, such as equity and debt instruments, and that channels savings and investment between suppliers of capital and users of capital (source: http://www.investopedia.com/terms/c/capitalmarkets.asp, accessed 28/02/2017).

also a process of capital augmentation and transformational restructuring (Sutherland, El-Gohari, Buckley, Voss 2010: 2).

Offshore companies established by Chinese investors do not serve only the function of holding companies in the restructuring of Chinese businesses, but they are also frequently used to structure JVs (合资经营企业 Hezi jingying qiye). JVs account for a relevant proportion in Chinese outward FDI, and they are structured primarily to serve as a means of sharing legal and financial risks in investment projects abroad. Using an offshore company to structure the investment, in fact, the Chinese investor can protect itself from liability or the risk of expropriation. The great majority of offshore companies used to structure JVs are established in the BVI, rather than in other offshore jurisdictions, because of its unique statutory provisions which are specifically aimed at the protection of investment in JVs[50] (Wilson 2014).

The determinants of the Chinese outward investment towards tax havens and OFCs, which in many cases lead to the consequent inward inflows of capital from the same jurisdictions, lie mainly in the imperfections of the Chinese capital market and other institutional factors, the investors' desire of gaining access to international financial markets and the preferential treatment accorded to foreign investors.

Chinese investors, hence, make use of tax havens and OFCs as a means for circumventing such domestic capital market and institutional imperfections (Sutherland, El-Gohari, Buckley, Voss 2010) and avoiding legal and administrative constraints. By establishing offshore companies, they are able to raise capital at a reduced cost, to restructure their domestic business inside China and to implement their short-term and long-term strategic objectives using the offshore companies, operating outside China (Buckley, Sutherland, Voss, Al-Gohari 2015: 17).

The establishment of offshore holding companies by Chinese investors through which channel investments may also be led by the desire of hiding the ultimate investment location from Chinese authorities, circumventing domestic approval requirements and avoiding possible interference and monitoring by authorities in the offshore operations (Ning, Sutherland 2012: 170).

Offshore entities also play a relevant role in the structuring of Variable Interest

50 The issue will be further investigated in the following chapter.

Entities (VIEs), which are structures that use contracts instead of shareholding to obtain corporate control over an operating entity. VIEs are commonly used in China both by foreign investors and Chinese ones: foreign investors use this structure in order to gain a controlling interest in a Chinese business operating in a restricted or prohibited sectors, or to invest in such sectors; whereas Chinese investors, in particular Chinese private firms, adopt it in order to raise capital on international capital markets or, inside the process of round-tripping, with the purpose of enjoying reduction in taxes and in regulatory costs back in China.

The underlying motivations and the drivers of the use of tax havens and offshore entities by Chinese investors are explained in detail in the following paragraphs.

2.3 Imperfections in the Capital Market

The capital market of China is generally considered not to be driven purely by market forces, hence is considered to be imperfect (Buckley, Sutherland, Voss, Al-Gohari 2015: 5): the imperfection of China's capital market, as mentioned before, is one of the major drivers of Chinese outward FDI.

First, it can be identified a differential treatment between State-Owned Enterprises[51] (SOEs, 国有企业 Guoyou qiye) and private enterprises (民营企业 Minying qiye)[52]: SOEs, due to their state-ownership, usually have a privileged access to capital through the state banking sector and also enjoy preferential status in obtaining other key inputs; usually they are the best financially performing enterprises because of such supervision by the central government on their activities, and they also enjoy privileged access to government networks and monopoly production rights. Moreover, before 2004, only approved SOEs had the right to invest overseas and access to foreign exchange.

51 A SOE is a legal entity that is either wholly or partially owned and operated by a government and is typically designated to participate in commercial activities. Normally, an SOE is a for-profit business entity, but in some cases there may be some SOEs that do not produce profits but are not permitted to go bankrupt, so they may receive government funding to continue their operations (source: http://www.investopedia.com/terms/s/soe.asp, accessed 27/02/2017).

52 A private enterprise is a business unit established, owned and operated by private individuals for profit; it is an economic activity undertaken by private individuals or independent companies under private ownership, rather than being controlled by the government.

By contrast, private firms have to face an unsupportive business environment and they are often discriminated with regard to the access to domestic capital market and natural resources (Ramasamy, Yeung, Laforet 2012: 21); because of the state control both on loans within Chinese banks and over domestic stock markets, they often encounter difficulties in raising capital and face more severe constraints in accessing Chinese capital market (Sutherland, El-Gohari, Buckley, Voss 2010).

The Chinese banking sector is dominated by the four-major state-controlled banks, which are Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), and Agricultural Bank of China (ABC); they provide around 75% of the total amount of commercial loans and are responsible for more than 50% of the total banking assets. These banks, because of the preferential policies established by Chinese government and their lack of competence in evaluating risks concerning private businesses, provide the overwhelming majority of loans to SOEs (Morck, Yeung, Zhao 2007: 14).

For these reasons, private business is more likely to look for alternative ways for raising capital, which often involve the choice of investing offshore: in this way, their purpose is to circumvent the difficulties they encounter in the domestic capital market. In fact, investing in tax havens and OFCs by establishing a holding company there is a way for private firms to augment their capital, also because such offshore vehicles provide an easier access to international listing on the major stock exchanges (Sutherland, El-Gohari, Buckley, Voss 2010: 4).

2.3.1 International Listing

Given the restricted access to domestic capital markets, the accessing of international capital markets through international listing is one of the alternatives that private firms can avail themselves of for the purpose of augmenting their existing capital (Buckley, Sutherland, Voss, Al-Gohari 2015); hence, one of the main reasons underlying the use of tax havens and offshore jurisdictions by Chinese enterprises is precisely to establish offshore vehicles with the purpose of undertaking public listings

on foreign stock markets.[53]

Tax havens and OFCs assist Chinese enterprises in their financing by providing a legally secure and internationally accepted platform to access international capital markets; in fact, offshore companies are accepted listing vehicles in the major stock exchanges (股票交易所 Gupiao jiaoyisuo) around the world, such as the New York Stock Exchange (NYSE), the London Stock Exchange and the Hong Kong Stock Exchange (HKEX).

Between 2000 and 2005, among the 18 Chinese IPOs listed on NASDAQ[54], 13 were incorporated in the Cayman Islands or in the BVI, while others were incorporated in United States or Hong Kong. Other Chinese IPOs listed on the HKEX, also, were undertaken through listing vehicles incorporated in the same tax havens (Wilson 2014: 219).

The majority of Chinese companies listed on international stock markets, hence, are held through offshore listing vehicles, which are incorporated in Cayman Islands, Bermuda and other offshore jurisdictions. Many of these listing vehicles incorporated in the Cayman Islands hold one or more BVI holding companies, which in turn hold subsidiaries located into China; the process followed by many companies, usually, includes the establishment of the holding company in the BVI, and then the incorporation of the listing vehicle in the Cayman Islands. By contrast, SOEs listed in international stock exchanges are usually incorporated within China.

Usually, the private enterprises that establish listing vehicles offshore are dynamic and fast-growing and, originally, they were incorporated in China (Ning, Sutherland 2012: 174); however, in order to support their growth and finance their expansion, at a certain point it was necessary for them to raise further capital and, as mentioned before, the easiest way for a private firm to circumvent the restrictions placed on the domestic capital market is to be publicly listed on foreign stock exchanges via an offshore listing vehicle.

The FDI towards tax havens and OFCs, therefore, originated primarily from the

53 The term "stock market" refers to markets and exchange where the issuing and trading of equities, bonds and other sorts of securities takes place, either through formal exchanges or over-the-counter markets. It is also known as "equity market" (source: http://www.investopedia.com/terms/s/stockmarket.asp, accessed 13/03/2017).

54 The acronym NASDAQ stands for National Association of Securities Dealers Automated Quotation.

private sector, but those investments are not only driven by the domestic capital market imperfections: other relevant factors are the relatively inadequate domestic institutional environments and the high transactions costs that private firms encounter in domestic capital markets.

Therefore, offshore investment can be considered as a form of "institutional arbitrage": Chinese private firms wish to avail themselves of more efficient institutions outside China (Sutherland, Matthews 2009: 5), and hence they engage in a form of arbitrage by choosing to bring their capital in offshore jurisdictions for the purpose of exploiting their efficient institutional environment.

In fact, institutional arbitrage is defined as:

> The strategic pursuit of an MNE to exploit differences in the configuration of the professional, administrative, cultural, economic, or geographic environment between countries to their own advantage.[55]

Offshore jurisdictions play a critical role in legal and practical issues: offshore entities serve as means of managing legal complexity in the operations, as they grant investors legal protection of their business by structuring them offshore (Wilson 2014: 216).

Another factor which heavily contributed to this has been the weak legal system in China with regard to the protection and enforcement of property rights, that is, Chinese investors decide to bring the capital abroad in order to have better protection of property rights and less capital control.

2.3.2 Mergers and Acquisitions (M&As)

The use of offshore jurisdictions as a means of circumventing imperfections in Chinese law can also be noticed in the frequent structuring of mergers and acquisitions (M&As, 兼并与收购 Jianbing yu shougou) involving Chinese companies through offshore entities; in fact, companies incorporated in Cayman Islands and BVI are often

55 BUCKLEY, SUTHERLAND, VOSS, EL-GOHARI (2015), "The Economic Geography of Offshore Incorporation in Tax Havens and Offshore Financial Centers: the Case of Chinese MNEs", *Journal of Economic Geography*, 15, 1, p. 23.

used to undertake an indirect acquisition of Chinese companies.

The motivations underlying the decision of structuring the acquisition of a Chinese company through an offshore entity are due to the fact that such transactions are not subject to Chinese jurisdiction and review and hence, as a consequence, the acquisition may be easier and less expensive.

Also, with regard to mergers, it is convenient to structure them through offshore companies because the merger regime in offshore jurisdictions, such as the BVI, is more efficient and allows cross-border mergers. A statutory merger according to BVI law, in fact, is often faster and less expensive: the provisions regulating mergers are contained in section 170 of the BVI Business Companies Act of 2004 and, under such provisions, it is only required shareholder approval by the holders of a majority of shares present and entitled to vote on the merger, unless the constitutional documents of the company require a greater percentage. With regard to cross-border mergers, section 174 (1) of the same Act states that:

> One or more companies may merge or consolidate with one or more companies incorporated under the laws of jurisdictions outside the Virgin Islands […] including where one of the constituent companies is a parent company and the other constituent companies are subsidiary companies.[56]

Hence, in order to circumvent such restrictions and expand the possibilities of structuring M&As both in China and in foreign countries, Chinese enterprises decide to exploit the offshore regimes in order to establish companies through which structuring their deals. Offshore jurisdictions offer an easy and effective solution to overcome the various forms of constraints imposed by the Chinese law.

2.3.3 The Case of Wuxi PharmaTech and Longcheer Holdings

It is possible to mention several private MNEs that decided to go offshore as their investment strategy, as a means of circumventing domestic capital market and institutional and regulatory constraints. Usually, the path followed by these firms is

56 BVI Business Companies Act 2004, http://www.bvifsc.vg/Portals/2/BVI_Business_Companies_Act_2004_Revised_1_1_06.pdf, accessed 14/03/2017.

similar.

As an example, Wuxi PharmaTech incorporated a holding company in the Cayman Islands, and after that held an Initial Public Offering[57] (IPO) on the NYSE in 2007, raising almost $200 million; in this way, it avoided Chinese capital markets and relied upon international investors for its financing. Moreover, the offshore holding company allowed the company to undertake substantial corporate action without the previous submission for the approval by the authorities.

A further example of a similar strategy is provided by Longcheer Holdings, a mobile phones producer, whose largest shareholder and cofounder is a Chinese national; it is incorporated in Bermuda and is listed in Singapore. It owns thirteen subsidiaries, including four investment holding companies based in Hong Kong, Singapore and Malaysia, seven Chinese subsidiaries and two subsidiaries in India and Hong Kong; all of these subsidiaries are owned by the listing vehicle incorporated in Bermuda, whose ultimate owner is a Chinese national: even if it has to be considered a Chinese company, all of its investment originate from Bermuda (Ning, Sutherland 2012).

2.4 Preferential Treatment for Foreign Investors

The use of tax havens and OFCs and the establishment of offshore holding companies by Chinese investors was driven also by several institutional "misalignments", such as the favorable treatment for foreign investors (Sutherland, El-Gohari, Buckley, Voss 2010: 4).

Since the late 1970s China had opened its economy and started welcoming foreign investment: in order to attract FDI within the country, China accorded a preferential treatment to foreign investment capital over domestic investment capital inside the country (Vlcek 2010: 128). The configuration of China's legislation and regulatory structure was conceived for attracting FDI flows, hence, it implemented two separate enterprise income tax regimes for domestic-invested enterprises and foreign-invested

57 An IPO is the process by which companies go from private to public, and it is the first time that the stock shares of a private company are offered to the public on a securities exchange. IPOs are usually issued by smaller and recently established companies, which seek to raise capital to expand, but can also be issued by large privately owned companies that want to become publicly traded (source: http://www.investopedia.com/terms/i/ipo.asp, accessed 28/02/2017).

enterprises.

FDI can take the form of greenfield investment[58] or mergers and acquisitions (M&As); with regard to greenfield investment, FDI have three different configurations: Equity JV[59] (EJV, 中外合资经营企业 Zhongwai hezi jingying qiye), Contractual JV[60] (CJV, 中外合作经营企业 Zhongwai hezuo jingying qiye) and Wholly Foreign-Owned Enterprise[61] (WFOE, 外商投资企业 Waishang touzi qiye); these three forms account for the majority of FDI flows into China, and can be collectively referred to as Foreign-Invested Enterprises (FIEs).

Chinese legal regime governing FIEs was first established in the 1980s. Currently, in China there are three legislations regulating FIEs: the Sino-Foreign Equity Joint Venture Law (EJV Law), the Sino-Foreign Contractual Joint Venture Law (CJV Law) and the Wholly Foreign-Owned Enterprise Law (WFOE Law).

The first one, the Law of People's Republic of China on Sino-Foreign Equity JVs (中华人民共和国中外合资经营企业法 Zhonghua renmin gongheguo zhongwai hezi jingying qiye fa), was promulgated in 1979, and then amended in 1990 and 2001 in order to comply with WTO requirements. In 1986, it was promulgated the Wholly Foreign-Owned Enterprise Law of the People's Republic of China (中华人民共和国外商投资企业法 Zhonghua renmin gongheguo waishang touzi qiye fa), amended in 2000, and in 1988 the Law of People's Republic of China on Sino-Foreign Contractual

58 A greenfield investment is a form of FDI where a parent company builds its business and operations in a foreign country from the ground up.

59 An EJV is a business entity formed between foreign investors and Chinese partners. The term "foreign investor" has a broad meaning, and could include foreign companies, enterprises, other economic organizations and individuals; the term "Chinese partner" includes all the previously mentioned categories except individuals. An EJV must take the form of a limited liability company incorporated in China, and the foreign investor's investment must be 25% or more of the EJV's registered capital (Huang 2009: 190).

60 As was for the EJV, a CJV is a business entity formed between foreign and Chinese investors; these two terms include the categories of investors mentioned above with regard to EJV, and also in the CJV they do not include individuals as Chinese partners. The difference a CJV is managed according to a JV contract, while an EJV is managed on the basis of the shareholding structure, where the Board of Directors is the ultimate management authority. Also, a CJV has not necessarily a legal person status (Huang 2009: 192).

61 The WFOE differs from EJV and CJV for the fact that, as the name suggests, it is wholly owned by foreign investors and is completely unconnected with Chinese ones. A WFOE includes enterprises established in China only by foreign investors and their capital, it is a legal person and can take the form of a limited liability company or other corporate forms; the term "foreign investor" refers to enterprises, other economic organizations or individuals (Huang 2009: 196).

Jvs (中华人民共和国中外合作经营企业法 Zhonghua renmin gongheguo zhongwai hezuo qingying qiye fa), amended in 2000.

These three laws, together with several amendments and regulations applied in the following decades, form a distinct body of law for foreign investors in China. There have been implemented several regulations throughout the years specifically regulating different aspects of FIEs, as an example, addressed to specific types of foreign investment, or directed to investment in specific industries; the drawback of this bulk of regulation was the lack of consistency of the legal regime on its whole.[62]

In fact, between the three laws governing FIEs, EJV Law, CJV Law and WFOE Law, and the Company Law there are conflicts and inconsistencies, in particular with regard to corporate governance issues, capital requirements and share transfers.[63]

On 9th April 1991, at the 4th Session of the 7th National People's Congress, it had been adopted the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, which came into effect on 1st July 1991, and replaced the existing Income Tax Law of the People's Republic of China for Chinese Foreign Equity Joint Ventures and the Income Tax Law of the People's Republic of China for Foreign Enterprises.

In 1993 was promulgated the Company Law of the People's Republic of China (中华人民共和国公司法 Zhonghua renmin gongheguo gongsifa); it is applied to all Chinese companies incorporated in the form of limited liability companies or joint stock companies,[64] including FIEs. It complements the specific FIEs' regime with respect to certain matters: in this way, FIEs are regulated at the same time by their specific legal system and the general system implemented by the general Company Law (Huang 2009). Moreover, to guide the examination and approval of foreign investments, in 1995 it had been promulgated a document entitled Catalogue for the Guidance of Foreign

62 SHENG, LIVDAHL, SIU, (2015), *China Issues Draft Foreign Investment Law*, https://www.pillsburylaw.com/en/news-and-insights/china-issues-draft-foreign-investment-law.html, accessed 28/03/2017.

63 NIU, ZENG (2015), *China's Draft Foreign Investment Law*, http://www.dentons.com/en/insights/articles/2015/march/5/chinas-draft-foreign-investment-law, accessed 28/03/2017.

64 A joint stock company is an business entity that falls between the definitions of a partnership and corporation in terms of shareholder liability (source: http://www.investopedia.com/terms/j/jointstockcompany.asp, accessed 29/03/2017).

Investment Industries (外商投资产业指导目录 Waishang touzi chanye zhidao mulu), also referred to as Catalogue, which divided the proposed foreign investment projects in four categories: encouraged, restricted and prohibited, whereas projects not falling under the previous three categories are considered permitted (Polack 2015: 10). The Catalogue is updated periodically, and the last version was released in March 2015; also in December 2016 it was issued a draft version of the Catalogue, which has a reduced number of restrictions on foreign investment.[65]

In this way, by creating a separate regime governing FIEs, China formed a dual and parallel system. Until 2008, foreign invested capital in the form of FIEs received various benefits when investing in China; such advantages included an improved access to land and other factor inputs, a reduction in land use fees, a greater autonomy in the enterprises' management and operation, favorable import tariff rates for components and equipment, favorable export tariff rates, less rigorous trade restrictions and exemptions from export quotas, special access to foreign exchange, no requirement to remit foreign exchange to the Central Bank or the State Administration of Foreign Exchange[66] (SAFE, 国家外汇管理局 Guojia waihui guanli ju) and tax concessions and holidays[67] (Sutherland, El-Gohari, Buckley, Voss 2010: 5).

Under Article 7 of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises of 1991, the income tax imposed on FIEs established in Special Economic Zones[68] (SEZs, 经济特区 Jingji tequ) and Economic and Technological Development Zones (国家级经济技术开发区

65 Baker McKenzie (2016), *Draft 2016 Foreign Investment catalogue – China Continues Opening Sectors to Foreign Investors*, http://www.bakermckenzie.com/en/insight/publications/2017/01/draft-2016-foreign-investment-catalogue/, accessed 29/03/2017.

66 The SAFE is an administrative agency of the People's Republic of China whose primary responsibilities are drafting policies and regulations governing foreign exchange market activities and manages the state foreign-exchange reserves.

67 A "tax holiday" is a government incentive program that offers a tax reduction or elimination to businesses. Tax holidays are often used to reduce sales taxes (that are consumption taxes imposed on the sale of goods and services) by local governments, but they are also commonly used in order to stimulate and attract foreign investment; they are often put in place in particular industries to help promote growth (source: http://www.investopedia.com/terms/t/tax-holiday.asp, accessed 27/02/2017).

68 SEZs are areas created with the specific purpose of attracting large amounts of foreign investment in order to promote the economic development of the country; in fact, they offer several benefits that facilitate the establishment of businesses there, such as exemption or reduction in taxes, financial services and other preferential treatments. The first China's SEZs were established in 1979, an they were located in particular on the east coast, in Guangdong and Fujian provinces: Shenzhen, Zhuhai, Shantou and Xiamen (Polack 2015: 5).

Guojiaji jingji jishu kaifa qu) was reduced at 15%, whereas the rate for domestic enterprises was fixed at 33%; also with regard to FIEs engaged in projects encouraged by the state, such as energy or communication, the rate was 15%. Also the income tax on FIEs established in coastal economic zones was reduced at 24%.

According to Article 8, FIEs of a production nature which were supposed to operate for at least ten years, were exempted from income tax in the first and second years after beginning making profits, and enjoyed a tax reduction of 50% for the following three years. Furthermore, FIEs engaged in agriculture, forestry or animal husbandry, and FIEs established in less developed areas, were entitled to a reduction of income tax between 15% and 30% for other ten years after the period of exemption or reduction already granted.

Under Article 19 (4), the income generated from the supply of technical know-how in scientific research, exploitation of energy resources, development of the communication industries and important technologies is also exempted from income tax, or the income tax rate is reduced.[69]

2.4.1 Round-tripping

When an economy is rapidly growing, as in the case of China, it creates huge amount of new capital, and it is common that a considerable proportion of such capital is directed abroad; in fact, investors have great incentives in bringing the capital abroad, such as the diversification of domestic risks and the pursuing of better protection of property rights.

It is also common that the capital brought outside China by Chinese investors creates the base for round-tripping FDI back into China when favorable opportunities arise. The weak legal system in China, which was not able to provide adequate protection and enforcement of property rights and contracts, is one of the driver of the flight of capital abroad through illicit channels such as the misinvoicing of imports and

69 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (1991), https://www.wto.org/english/thewto_e/acc_e/chn_e/WTACCCHN46_LEG_5.pdf, accessed 27/02/2017.

exports (Xiao 2004).

In particular, the preferential treatment accorded to foreign investment in China lead, as a consequence, to the round-tripping of investment. Given the unfavorable circumstances, Chinese capital started to be channeled out of China and to be invested in tax havens and OFCs and then redirected back into China in the form of FDI through offshore holding companies. In doing this, Chinese investment capital disguised as foreign investment could benefit from such favorable treatment.

Because the FDI that arrive into China had before originated in the Chinese economy itself, the phenomenon of round-tripping inflates the FDI inflows statistics; a significant proportion of Chinese FDI are round-tripped, primarily through Hong Kong and the Caribbean tax havens Cayman Islands and BVI. According to estimation, round-tripping FDI currently account for 33% of China's total FDI inflows (Chen 2013: 200).

The basic procedure of such round-tripping of capital is simple: a Chinese investor establishes a firm in a tax haven or offshore jurisdiction which become the holding company of a Chinese firm; the capital and the equity of the firm is then restructured so that the investment made by the offshore company into China appears to be foreign and so it is subject to the preferential treatment accorded by the government. The offshore holding company does not undertake any substantial operation, and merely serves the function of “shell company” or “paper company” for investing the Chinese capital back into China in the form of foreign capital originated from outside the country.

2.4.2 Enterprise Income Tax Law (EIT Law)

A change in the corporate income tax regime occurred since the implementation of the new Enterprise Income Tax Law of the People's Republic of China (中华人民共和国企业所得税法 Zhonghua renmin gongheguo qiye suodeshui fa), the EIT Law, which replaced the existing Income Tax Law of the People Republic of China on Foreign-Investment Enterprises and Foreign Enterprises (FIE Income Tax Law). The new EIT Law had been adopted at the 5th Session of the 10th National People's Congress of the People's Republic of China on 16th March 2007, and entered into effect on 1st January 2008.

The major reform of the EIT Law was the unification of the tax rates for foreign-invested and domestic-invested enterprises, and the elimination of the differential and preferential treatment accorded before to foreign investment. Before the promulgation of the new EIT Law, the enterprise income tax rate for domestic enterprises was established at 33%, while for foreign ones it was 15%; whereas Article 4 of the new law assessed the rate for both domestic and foreign enterprises at 25%. This law also eliminated or modified many of the tax incentives and holidays that existed before (Chen 2013: 200). Therefore, the EIT Law changed some of the dynamics underlying the attractivity of FDI into China.

One of the reasons behind the implementation of this new law could be the sufficient development and maturity of Chinese economy, so that it was no longer necessary to accord a preferential treatment to foreign investment with the purpose of attracting them into the country (Vlcek 2010: 129). However, a tax rate of 25% is still lower than the average rates in foreign countries: the average enterprise income tax is around 28.6% around the world, and is nearly 26.7% in China's neighboring countries; hence, 25% can still be considered competitive and attractive for international investors (Li 2007: 524).

The new EIT Law also introduced a new concept of "tax resident enterprise". Previously, only resident enterprises (居民企业 Jumin qiye), that is, enterprises incorporated in China under Chinese law, were taxed on their worldwide income; non-resident enterprises (非居民企业 Fei jumin qiye), that is, enterprises incorporated outside China under foreign law, were not taxable in China. Non-resident enterprises were taxed only on the income derived from activities within the country (Li 2007: 525). This general rule was applied indifferently, and did not take into consideration the nationality of the ultimate owners of the business and the location where the effective management and control took place (Sharkey 2007: 837). As a consequence, the taxation was easily avoided by Chinese businesses just by incorporating their holding company in an offshore jurisdiction, while the management decisions and the effective control were in fact undertaken by Chinese parties within China.

Differently, under the EIT Law, it is made a distinction between resident and non-resident enterprises based on the location of the actual management organ (实际管理机

构 Shiji guanli jigou): in fact, Article 2[70] of EIT Law states that:

> The term "resident enterprise" as mentioned in the present Law means an enterprise which is set up under Chinese law within the territory of China, or set up under the law of a foreign country (region) but whose actual management organ is within the territory of China. The term "non-resident enterprise" as mentioned in the present Law means an enterprise which is set up under the law of a foreign country (region) and whose actual management organ is not within the territory of China but who has organs or establishments within the territory of China, or who does not have any organ or establishment within the territory of China but who has incomes sourced in China.[71]

Article 3 of the EIT Law states that a enterprises which is considered resident according to the criteria established in Article 2 has to pay the enterprise income tax for the income sourced from both inside and outside China; whereas, in case the enterprise is non-resident, it has to pay the enterprise income tax on the income sourced inside China and on the income sourced outside China in the case that it had established an organ within China and such income would be actually connected with such organ.

As previously mentioned, under the EIT Law of 2008, FIE would not receive any more the preferential tax status that they had benefited from before. Some of the provisions of the EIT Law included the payment of dividends, interests, rent or royalties from a FIE to its foreign non-resident enterprise investors, which are now subject to a withholding tax of 10%. Under the previous taxation system, dividends paid by FIEs to foreign investors were specifically exempted from withholding tax.

However, EIT Law includes also a provision stating that, in the case that the country of incorporation of the foreign enterprise investor has a bilateral tax treaty with China on reduced withholding tax rates, the withholding tax could be reduced. In the

70 Original version in Chinese language: "本法所称居民企业，是指依法在中国境内成立，或者依照外国(地区)法律成立但实际管理机构在中国境内的企业。本法所称非居民企业，是指依照外国（地区）法律成立且实际管理机构不在中国境内，但在中国境内设立机构、场所的，或者在中国境内未设立机构、场所，但有来源于中国境内所得的企业 (Benfa suo cheng jumin qiye, shi zhi yifa zai Zhongguo jingnei chengli, huozhe yizhao waiguo (diqu) falu chengli dan shiji guanli jigou zai Zhongguo jingnei de qiye. Benfa suo cheng fei jumin qiye, shi zhi yizhao waiguo (diqu) falu chengli qie shiji guanli jigou bu zai Zhongguo jingnei, dan zai Zhongguo jingnei sheli jigou, changsuo de, huozhe zai Zhongguo jingnei wei sheli jigou, changsuo, dan you laiyuanyu Zhongguo jingnei suode de qiye)", http://www.chinatax.gov.cn/n810219/n810744/n1671176/n1671186/c1706857/content.html, accessed 31/03/2017.

71 Enterprise Income Law of the People's Republic of China (2008), http://www.fdi.gov.cn/1800000121_39_3339_0_7.html, accessed 28/02/2017.

case of Hong Kong, it had signed in August 2006 an Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion, which is referred to as Double Tax Agreement.

Hence, the withholding tax that FIEs in China are required to pay to their holding company in Hong Kong is only 5%: as a consequence, many enterprises resident in Mainland China established a holding company in Hong Kong in order to benefit from such tax reduction (Sutherland, El-Gohari, Buckley, Voss 2010: 12). As a consequence, holding companies located in Hong Kong may be considered as a means of circumventing the new withholding tax introduced by the EIT Law on dividends paid to other offshore jurisdictions and tax havens, and they were specifically introduced for this purpose.

A representative example of this strategy is given by Action Semiconductor: it incorporated in Cayman Islands in 2005, with the purpose of gaining access to international capital markets and exploiting the greater flexibility for future operations given by the offshore structure. It held an IPO on the NASDAQ in 2005 and then established several holding companies in the BVI which held its Chinese subsidiaries.

Before the new EIT was officially introduced, the company started to reconfigure its organizational structure, that is, it reconfigured the system of ownership between the offshore holding companies and the Chinese subsidiaries in order to circumvent the effect of the new withholding tax introduced by the EIT Law. Action Semiconductor, hence, in 2007 established two subsidiaries in Hong Kong, which served as holding companies for the Chinese subsidiaries originally held by the BVI holdings (Sutherland, El-Gohari, Buckley, Voss 2010). This was clearly a preventive measure that preceded the legal and regulatory changes that would have happened in China within a short time.

2.4.3 Consequences of EIT Law

The EIT Law was intended to provide a fair competition environment between domestic and foreign enterprises, and its purposes also included improving China's economic structure, promoting its development and, at the same time, safeguarding tax sovereignty (Weichenrieder, Xu 2015: 7).

By unifying the tax treatment for foreign-invested and domestic-invested enterprises, the reform also addressed the issue of round-tripping. In fact, it eliminated the incentives for round-tripping, that is, it eliminated the differential tax rate which was one of the main drivers for Chinese capital to be invested in offshore location in order to disguise its Chinese identity and return into China in the form of foreign capital. Indeed, under the EIT Law, the income that originate inside China, produced both by domestic and foreign-invested enterprises, has to be taxed at the same rate.

However, if on one hand EIT Law harmonizes Chinese tax policy with international standards and fulfils the commitments that China had made to the WTO with regard to an equal treatment for domestic and foreign investors, on the other hand it has little real effect on round-tripping FDI in China, because it still provides some preferential provisions.

In fact, under article 27 of the EIT Law, the enterprise income tax may be reduced or exempted with regard to the income generating from specific sectors. In particular, this reduction refers to the income generated from the engagement in agriculture, forestry, husbandry and fishery, the income generated from investment in the business operations of the important public infrastructure projects supported by the state, the income generated from projects of environmental protection, energy and water saving and from transferring technologies. Article 28[72] further specifies that:

> As regards a small meagre-profit enterprise satisfying the prescribed conditions, the enterprise income tax shall be levied at a reduced tax rate of 20%. As regards important high-tech enterprises necessary to be supported by the state, the enterprise income tax shall be levied at the reduced tax rate of 15%.[73]

Reductions are also enjoyed by enterprises engaged in research and development of new technologies, new products and techniques.

Other exemptions are included in article 57 of the EIT Law, which accords further

72 Original version in Chinese language: "符合条件的小型微利企业，减按20%的税率征收企业所得税。国家需要重点扶持的高新技术企业，减按15％的税率征收企业所得税 (Fuhe tiaojian de xiaoxing weili qiye, jian an 20% de shuilü zhengshou qiye suodeshui. Guojia xuyao zhongdian fuchi de gaoxin jishuqiye, jian an 15% de shuilü zhengshou qiye suodeshui)", http://www.chinatax.gov.cn/n810219/n810744/n1671176/n1671186/c1706857/content.html, accessed 31/03/2017.

73 Enterprise Income Law of the People's Republic of China (2008), http://www.fdi.gov.cn/1800000121_39_3339_0_7.html, accessed 28/02/2017.

preferential treatments to enterprises falling into certain categories: enterprises which had been set up before the implementation of EIT Law are allowed to continue to enjoy the preferential treatment for five years after the promulgation of the Law; the tax rate imposed to them is gradually transferred to the level prescribed by the new Law, and has to reach the prescribed 25% within the five years.

In particular, FIEs established in SEZs, which were benefiting from a lower tax rate of 15% under the previous law, and enterprises in the less developed area of the West, can still benefit from tax holidays and reductions (Wei 2008: 854). Under the same article of EIT Law, also high-technology enterprises and other enterprises engaged in business included in the encouraged categories are allowed to enjoy transitional preferential treatments and preferential treatments of tax reduction or exemption.

Furthermore, the EIT also attempted to counteract the tax evasion by Chinese nationals accomplished by establishing offshore entities and shifting profits outside China for tax minimization purposes. Article 45 states that, in case an enterprise set up or controlled by a resident enterprise or a Chinese resident in a country or region where the actual tax burden is lower than the rate prescribed by EIT Law, and in case such enterprise does not distribute profits or decreases the distribution of profits for reasons not reasonably connected with business operations, the portion of such profit which is to attribute to the Chinese resident enterprise has to be included in its taxable income and has to be subject to the enterprise income tax.

Undoubtedly, since the implementation of the new EIT Law in 2008, the incentives for round-tripping had decreased remarkably. The issue of round-tripping was also previously addressed in 2005 by Circular No. 75 of the SAFE, which required Chinese nationals to register with the local SAFE branch before establishing or controlling any offshore company for the purpose of offshore equity financing which owns assets or equity in a Chinese company; also, in 2006, it was promulgated the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (M&A Rules), which required the approval of central government for any overseas investment, with the specific intention of rejecting any project of round-tripping (Wilson 2014: 216).

Although Chinese government tried to address the issue of round-tripping of

capital and tried to limit it, the measures implemented did not entirely eliminated the presence of tax havens in Chinese investment and business. In fact, the use of offshore jurisdictions in Chinese FDI has continued and is still consistent, and this can be explained by the fact that the round-tripping of funds is not the only driver of such process, but also the other key factors, as previously explained, are crucial in the exploitation of tax havens in Chinese investment.

2.5 Variable Interest Entity (VIE)

2.5.1 Accounting origins

The Variable Interest Entity (VIE) is a corporate structure that uses contracts instead of shareholding to exercise corporate control. The term has its origin in accounting, and was created in order to redefine what constituted a controlling financial interest, in order to determine when a firm has to consolidate the VIE's financial statements; the purpose was to prevent the manipulation of subsidiaries' financial statements in order to hide losses and generate earnings (Chapman 2016: 1).

In its Accounting Research Bulletin 51, also called ARB 51, the US Financial Accounting Standard Board (FASB) defined the controlling financial interest as the ownership of a majority voting interest, which means the direct or indirect ownership by an entity of more that 50% of the voting shares of another entity. All the entities in which a parent has a controlling financial interest have to be consolidated[74].

However, due to the increasing adoption of VIEs to carry on transactions, the provisions set by ABR 51 were not sufficient, because in many consolidated financial statements VIEs in which the parent had a controlling financial interest were not included. Hence, given that the voting interest approach was not effective in identifying the controlling financial interest in entities that were not controlled through voting rights, in 2003 the FASB issued Interpretation No. 46, also called FIN 46, which specifically addressed the VIE structure and stipulated the criterion for its consolidation

74 FASB, *ARB 51: Consolidated Financial Statements*, http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820901468&blobheader=application%2Fpdf, accessed 3/04/2017.

in financial statements. In particular, FIN 46 stipulated that:

> The primary beneficiary of a variable interest entity is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interest, which are the ownership, contractual, or other pecuniary interests in an entity.[75]

2.5.2 Use of VIEs in China

Basically, the VIE structure is the result of a complex frame of contracts securing the control over a domestic operating entity by an offshore vehicle.

It is adopted in China to serve two purposes: first, it is adopted by Chinese companies and foreign investors with the purpose of circumventing the restrictions imposed on foreign direct ownership and foreign investment in restricted sectors of Chinese industry (Guo 2014: 574); that is, it allows Chinese private firms to acquire foreign capital, and allows foreign investors to gain access in sectors that otherwise would be prohibited. Second, it is used to restructure a Chinese business offshore in order to benefit from tax and regulatory benefits back in China: the offshore holding entity is adopted in order to acquire a China-based company, that is precisely the previously mentioned process of round-tripping (Chapman 2016: 4).

The VIE structure complies in form, but not in substance, with the Chinese law, and hence is adopted as a regulatory loophole to Chinese restrictions. It provides a "creative compliance" mechanism.

The VIE structure first appeared in 2000, as a means of circumventing the restrictions in particular in sensitive sectors such as internet, telecommunications and energy; this structure allows foreign investors to purchase shares in an offshore entity, commonly a shell company incorporated in tax havens such as the Cayman Islands (Lin, Mehaffy 2016: 444).

The first Chinese company that adopted this structure was Sina Corporation, which used a VIE structure in order to acquire an offshore public listing in 2000 (Johnson 2015: 252), in fact, the VIE structure is also referred to as Sina-model

75 FASB Interpretation No. 46, *Consolidation of Variable Interest Entities. An Interpretation of ARB No. 51*, http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true, accessed 3/04/2017.

structure, from the name of the first company that adopted it.

As mentioned before, in China foreign investments are regulated under the Catalogue for the Guidance of Foreign Investment Industries, which divides Chinese industries into three categories: encouraged, restricted and prohibited. Foreign investments in the industry sectors included in the encouraged section do not face restrictions, those in restricted sectors are subject to strict control and review, and the governmental approval is often obtained but with less easy procedures; whereas in prohibited sectors foreign investment are not allowed under any circumstances, and non-Chinese investors cannot invest or own equity in a company operating in a prohibited industry (Ziegler 2016: 546).

As an example of prohibited industries, there are telecommunications and the Internet sector, in which the VIEs are mainly used: foreign investment in these sectors are not allowed and also the foreign ownership in China-based companies is forbidden (Johnson 2015: 252).

After its accession to WTO in December 2001, China had made several commitments that were intended to further liberalize and modernize its economy and its regime regarding foreign investment. As an example, many restrictions previously imposed on foreign investment were removed and the supervision and regulatory regime on foreign activities became less stringent; also, China committed to apply more extensively the national treatment to foreign investment. In addition, China was forced to loosen the prohibition imposed on foreign investment in certain Chinese industries, and in particular it was required to open to foreign investors certain industry sectors that under the Catalogue were considered restricted and prohibited. In fact, under WTO requirements, China had to immediately permit foreign investors to acquire up to 25% of equity in telecoms companies; then, within a period of three years, it would have to increase the percentage up to 49%.

However, despite China's formal compliance to WTO requirements regarding foreign investment, it had been very difficult for foreign investors to acquire equity in telecoms business, even if the percentage of foreign equity was less than 50%; this means than, although foreign equity in sectors such as the telecommunications were permitted up to 50%, basically it had been very infrequent that the government authority

had given the approval (Shen 2012: 930).

As a consequence of this context of regulatory constraints, the VIE structure has been precisely adopted in order to circumvent the restrictions imposed on foreign investment in these prohibited industries.

The structure of a VIE is composed of several corporate entities linked together through various layers of contractual relationships and equity ownership; the VIE is specifically designed with the purpose of appearing to the Chinese government as a completely legal structure entirely under Chinese ownership and with no foreign investment (Ziegler 2016: 541). Although the VIE appear, in form, to be legal and to abide by Chinese law, in substance it is created with the purpose of allowing foreign investors to operate in prohibited industries and, in fact, it is made in violation of the law.

Therefore, the VIE structure is commonly used by Chinese companies to list on overseas stock exchanges. In order to undertake an IPO, Chinese companies can either list on domestic markets, also known as A-share listing, or on offshore stock exchanges, known as red-chip listing: the requirements for the listing on domestic stock exchanges are usually more severe and time-consuming than the offshore listing; for avoiding the troublesome procedures imposed by Chinese government and to undertake the IPO more quickly, Chinese companies commonly prefer the red-chip listing. For the offshore listing, Chinese companies can choose the straight-forward offshore listing structure or the VIE structure; in order to circumvent the restrictions imposed by the Chinese government on foreign investment, usually the VIE structure is preferred.[76]

As mentioned before, the preferred listing vehicle is an offshore holding company usually incorporated in the Cayman Islands, the BVI or Hong Kong due to tax minimization purposes and regulatory and legal concerns. The listing vehicle is established in the form of a SPV and is part of a VIE structure; the SPV is listed abroad to raise finance, in order to avoid Chinese securities regulations and the difficulties in listing on domestic stock exchanges (Shen 2012: 932).

Today, nearly half of the Chinese companies listed on NYSE and NASDAQ are

76 ZENG, Xianwu BAI, Lihui (2012), *Variable Interest Entity Structure in China*, China Law Insight, http://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/, accessed 3/04/2017.

using a VIE structure with the specific purpose of circumventing the restrictions that Chinese law imposes on the selling of stock to foreign investors (Ziegler 2016: 541).

In particular, many Chinese internet companies used the VIE structure in order to achieve the offshore listing, such as Alibaba, Tencent, Baidu, Sina, Tudou; this structure has also been adopted by media companies such as Focus Media, Vision China Meida and Bona, and by retail companies and companies operating in other industries.[77]

Moreover, thanks to the process of restructuring of the business through an offshore SPV, the VIE structure provides tax, economic and regulatory benefits also to Chinese firms or shareholders. In fact, as mentioned above, before the implementation of the new EIT Law in 2008, FIEs were subject to a 15-20% income tax rate, whereas, for domestic enterprises it was 33%: by using a VIE, Chinese investors could enjoy a more favorable tax treatment while conducting the same business.

Also after the promulgation of the EIT Law business structured using a VIE structure can enjoy a preferential treatment: in fact, the SPV has to pay only a withholding tax on the dividends received from the WFOE, which is at a rate of 10% in case of a tax treaty is applied, and may be only 5% in the case the SPV is incorporated not in a Caribbean tax haven but in Hong Kong. As a consequence, the payment of dividends made to the SPV and the capital gains originated from the sale of shares in the SPV are not taxable under China's law.

The VIE structure is widely adopted by foreign investors operating in China also because the structuring of the business through an offshore entity provides legal and regulatory advantages: tax havens are common law jurisdictions and have a stable political and economic environment, and they implement international and higher standards with regard to the company law applied and in terms of protection of property rights. Hence, the regulatory regime implemented in offshore jurisdictions better supports various stages of debt and equity financing, reduces the transaction costs and ensures a better protection of the investment, by avoiding the troublesome and instable Chinese regulations (Shen 2012: 933).

77 ZENG, Xianwu BAI, Lihui (2012), *Va*riable Interest Entity Structure in China, China Law Insight, http://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/, accessed 3/04/2017.

2.5.3 Structure of the VIE

The structure of a VIE is composed of at least three entities: first, there is an actual Chinese company, which is the truly operating business and is legally owned by a Chinese national with no foreign partners or shareholders; hence, this China-based company is legally allowed to carry on business in industries that are restricted or prohibited to foreign investors. The second entity is a WFOE, a shell company established in China that has the only purpose of serving as a connection between the first entity and the third one, that is another shell company incorporated offshore (Johnson 2015: 253).

The last entity, the offshore one, is the true core of the VIE structure, and is incorporated as an offshore holding company in the form of SPV, usually in a tax haven, because such jurisdictions are common law jurisdictions with a preferential treatment with regard to taxation. Commonly, the preferred jurisdictions are Cayman Islands, the British Virgin Islands, Bermuda or Hong Kong. The SPV owns 100% of the China-Based WFOE and it is listed on overseas stock exchanges, in particular US or Hong Kong, selling its shares to foreign investors; commonly, the SPV does not undertake any operation (Chapman 2016: 5).

The connections between the three entities are made through a series of contractual agreements. The first two entities, the Chinese operating business entity and the WFOE, both located in China, are linked through Chinese contracts, which stipulate that the WFOE will receive profits and liabilities from the Chinese company in exchange for financing and other consulting services; these contractual agreements are built in order to effectively structure the ownership relationship between them with the Chinese company acting as the parent company and the WFOE as the subsidiary.

The second connection is between the WFOE and the offshore holding company, which directly owns the WFOE. The ownership of the WFOE by the foreign company is legal because the WFOE is no directly involved in the prohibited industry, but is related to it only through the contractual agreement that links itself to the first entity, which is the truly operating business; hence, the offshore entity does not appear as effectively involved in a prohibited industry sector and the ownership abide by Chinese

law.

The complete structure, hence, is realized with the bridge between the Chinese operating business and the WFOE accomplished by contract and the bridge between the WFOE and the offshore holding company accomplished by ownership (Ziegler 2016: 548.

In the VIE structure two mechanisms are put in place: a control mechanism and a cash extraction mechanism. The control mechanism is established between the WFOE and the nominee shareholders through contracts, so that the nominee shareholders will act on behalf of the WFOE as the shareholders of the Chinese operating company; in the same time, the WFOE has complete control over the operating company through various contracts. These complex mechanisms made of contracts has the purpose of securing the control of the ultimate shareholders of the SPV and also allowing those shareholders to exercise effective corporate control over the China-based operating business.

Also, the cash extraction mechanism is established between the operating company and the WFOE, so that the WFOE is entitled to receive the revenues of the first entity and, consequently, they are channeled to the offshore SPV (Shen 2012: 931).

In this way, through the ownership of the WFOE, the offshore entity becomes entitled to the profits and liabilities of the Chinese company; in the same time, this structure satisfies the government requirements because it appears that a Chinese national legally owns the company operating in the prohibited industry without foreign partners or shareholders (Ziegler 2016: 548). The operating control, in fact, remains inside the Chinese company, in order to abide by the Chinese law, while foreign investors enjoy economic benefits thanks to the complex structure of contractual arrangements (Johnson 2015: 253).

2.5.4 M&A Rules

The VIE structure, given its proliferation and its frequent adoption by Chinese companies, has attracted the attention of Chinese authorities, which has made attempts to regulate and restrict its use in certain sectors. Various regulations issued in recent

years have expanded the requirements imposed on foreign investors that wish to acquire companies or assets in China, and also the complexity of such requirements have been increased. Moreover, newly issued regulations addressed the VIE structure, and started to raise the problem of the validity of such structure employed by Chinese companies with the purpose of circumventing restrictions (Johnson 2015: 257).

The Regulations for Merger with and Acquisition of Domestic Enterprises by Foreign Investors (关于外国投资者并购境内企业的规定 Guanyu waiguo touzizhe binggou jingnei qiye de guiding), also referred to as M&A Rules, was issued by the Ministry of Commerce of the People's Republic of China (MOFCOM, 中华人民共和国商务部 Zhonghua renmin gongheguo shangwubu), the SAFE and other four government authorities in 2006, and included the VIE structure in its provisions. The requirements imposed by the M&A Rules include the disclosure of the offshore shareholding structure to MOFCOM, and require the approval of the same authority before the establishment of an offshore SPV. Article 11[78], in fact, stipulates that:

> The domestic companies, enterprises or natural persons shall, when they merge or acquire domestic companies having something to do with them in the name of the companies in foreign countries legally established or controlled by them, be submitted to the Ministry of Commerce for approval. The person concerned shall not evade above requirements by domestic investment of the foreign-invested enterprises or by other means.[79]

The stricter requirements imposed by M&A Rules tried to impose the governmental approval on every transaction in which domestic companies were involved, trying to make it impossible to avoid the approval through various strategies

78 Original version in Chinese language: "境内公司、企业或自然人以其在境外合法设立或控制的公司名义并购与其有关联关系的境内的公司，应报商务部审批。当事人不得以外商投资企业境内投资或其他方式规避前述要求 (Jingnei gongsi, qiye huo ziranren yi qi zai jingwai hefa sheli huo kongzhi de gongsi mingyi binggou yu qi you guanlian guanxi de jngnei de gongsi, ying bao shangwubu shenpi. Dangshiren bu deyi waishang touzi qiye jingnei touzi huo qita fangshi guibi qianshu yaoqiu)", Zhonghua renmin gongheguo shangwubu 中华人民共和国商务部（2006），Guanyu waiguo touzizhe binggou jingnei qiye de guiding 关于外国投资者并购境内企业的规定 http://www.mofcom.gov.cn/aarticle/b/c/200608/20060802839585.html, accessed 4/04/2017.

79 MOFCOM (2006), *Regulations for Merger with and Acquisition of Domestic Enterprises by Foreign Investors*, http://english.mofcom.gov.cn/aarticle/policyrelease/domesticpolicy/200610/20061003434565.html, accessed 4/04/2017.

involving offshore entities. However, it is argued that the issuing of M&A Rules made the VIE structure more attractive for Chinese companies with the purpose of circumventing the requirement of governmental approval; in fact, after the promulgation of the Rules, still many Chinese enterprises decided to adopt such structure[80].

The adoption of VIE structure has been made possible because, given its hybrid and complex structure, there was not any legislations specifically addressing it; however, it is evident that Chinese government has been making several efforts in order to tighten the supervision and prohibiting any circumvention of the regulatory constraints through offshore entities and contractual arrangements.

In 2011, the MOFCOM issued the Provisions for the Implementation of the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors, in which Article 9[81] provides that:

> With regard to the merger and acquisition of domestic enterprises undertaken by foreign investors, the authorities should judge whether such transaction is subject to the security review based on the essential content and actual impact of the transaction. Foreign investors shall not avoid M&A security review through any means, including but not limited to commissioned shareholdings, trusts, multi-level investments, leases, loans, contractual control, and overseas transactions.[82]

The contractual control is a clear reference to the VIE structure, in which the

80 ZENG, Xianwu BAI, Lihui (2012), *Variable Interest Entity Structure in China*, China Law Insight, http://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/, accessed 3/04/2017.

81 Original version in Chinese language: "对于外国投资或并购境内企业，应从交易的实质内容和实际影响来判断并购交易是否属于并购安全审查的范围；外国投资者不得以任何方式实质规避并购安全审查，包括但不限于代持、信托、多层次在投资、租赁、贷款、协议控制、境外交易等方式 (Duiyu waiguo touzi huo binggou jingnei qiye, ying cong jiaoyi de shizhi neirong he shiji yingxiang lai panduan binggou jiaoyi shifou shuyu binggou anquan shencha fanwei; waiguo touzizhe bu deyi renhe fangshi shizhi guibi binggou anquan shencha, baokuo dan bu xianyu daichi, xintuo, duoceng ci zai touzi, zulin, daikuan, xieyi kongzhi, jingwai jiaoyi deng fangshi)", Zhonghua renmin gongheguo shangwubu 中华人民共和国商务部（2011），Shangwubu shishi waiguo touzizhe binggou jingnei qiye anquan shencha zhidu de guiding 商务部实施外国投资者并购境内企业安全审查制度的规定，http://www.mofcom.gov.cn/aarticle/b/c/201108/20110807713530.html, accessed 4/04/2017.

82 MOFCOM (2011), *Announcement No. 53 of 2011 of the Ministry of Commerce of the People's Republic of China Concerning the Provisions of the Ministry of Commerce for the Implementation of the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors,* http://english.mofcom.gov.cn/article/policyrelease/aaa/201112/20111207869355.shtml, accessed 4/04/2017.

effective control over the Chinese operating company is achieved through a series of contractual agreements; hence, according to the content of the Article, the VIE structure is considered as a means to avoid the Chinese regulatory restrictions and thus it is argued the validity of such structure under Chinese law.

However, the Provision of 2011 imposed the national security review not on every M&A deals, but only on those businesses involving national defense security issues, such as military industry enterprises and other enterprises relevant to the national security in China, or national economic security issues, such as major agricultural products, natural resources and energy industries, important infrastructure projects, transportation services, key technologies, and other important equipment related to national security.[83]

It is evident that the increasing use of VIEs has attracted the attention of the authorities, which has made attempts to restrict the use of VIEs in certain sectors; however, it is still left an unregulated margin in which VIE structures may be adopted as it was before. As an example, the internet sector, that is the main sector in which VIE structures are used, it is not mentioned and thus it is possible for internet companies to adopt such structures, exploiting the existing loopholes in the legislation.

Not only the M&A Rules and the following related legislations were intended to address the VIEs used for restructuring the business in China, but also the new Foreign Investment Law, which has been published in the draft version in 2015, includes several provisions that have effects on the use of VIE structures: as will be explained in paragraph 2.6, under the provisions of the new Draft Law, VIE are treated as foreign investment because the ultimate shareholders of the SPV are non-Chinese nationals.

2.5.5 The Case of Alibaba

Alibaba is an internet company and hence, according to Chinese restrictions on foreign investment, cannot have foreign investors as stockholders: it is one of the many Chinese internet companies that utilized the VIE structure for circumventing such

83 ZENG, Xianwu BAI, Lihui (2012), *Variable Interest Entity Structure in China*, China Law Insight, http://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/, accessed 3/04/2017.

restrictions on foreign investment and obtaining a listing on the US stock exchange.

It was founded in 1999 by Jack Ma, and has rapidly became the largest e-commerce company. In 2014, Alibaba Group Holding Limited launched an IPO on the NYSE using a VIE structure: it has been the largest IPO in the story of US stock exchange using a VIE structure, raising $25 billion.[84]

Before shifting to the NYSE, Alibaba tried to list on the HKEX, but its proposed IPO was rejected: Alibaba wanted to structure its IPO with a dual-class voting scheme, which is not permitted on the HKEX. Through the dual-class voting scheme, the founders of the company can maintain a high control over the company after it went public by issuing two classes of stock with different voting rights; unequal voting shares are designed to give specific shareholders the voting control, and hence maintaining the control over the company, but at the same time allow the company to raise finance through a listing in the public equity market.[85]

HKEX banned the dual-class voting structure in 1987, because, by issuing shares with different voting rights, this structure violated HKEX's rule of "one shareholder, one vote"; however, this scheme is accepted in the US stock exchanges, and so Alibaba launched there its IPO in 2014 (Wei, Young 2015: 4).

In the SEC Form F-1, that is the securities registration statement required before the listing on the US stock exchange, it is disclosed Alibaba's corporate structure, and it is mentioned the use of a VIE in order to carry on its business operations.

As stated in the section "Our corporate structure", Alibaba Group Holding Limited was established in 1999 in the Cayman Islands as the holding company; Alibaba carries on its business in China through various subsidiaries and VIEs.

In particular, the most relevant Alibaba's subsidiaries are the following: Taobao Holding Limited, an exempted company incorporated under the law of Cayman Islands, which is the wholly-owned subsidiary of Alibaba and the indirect holding company of other Chinese subsidiaries; Taobao China Holding Limited, that is a limited liability company established in Hong Kong, which is the direct wholly-owned subsidiary of Taobao Holding Limited; Taobao (China) Software Co., Ltd., a limited liability

84 Financial Times (22 September 2014), *Alibaba IPO hits record $25bn*, https://www.ft.com/content/0f97cc70-4208-11e4-a7b3-00144feabdc0, accessed 3/04/2017.
85 http://www.investopedia.com/articles/fundamental/04/092204.asp, accessed 5/04/2017.

company incorporated under Chinese law, which is an indirect subsidiary of Taobao Holding Limited and a WFOE; Zhejiang Tmall Technology Co., Ltd., a limited liability company incorporated under Chinese law, that is an indirect subsidiary of Taobao Holding Limited and a WFOE; Alibaba.com Limited, an exempted company incorporated with limited liability under the law of Cayman Islands, which is the wholly-owned subsidiary of Alibaba and the indirect holding company of various Chinese subsidiaries; Alibaba.com Investment Holding Limited, a limited liability company incorporated under the law of BVI, which is the direct wholly-owned subsidiary of Alibaba.com Limited; Alibaba Investment Limited, a limited liability company incorporated under the law of BVI, which is the wholly-owned subsidiary of Alibaba and the main holding company for the group's strategic investment. Alibaba conducts its business through nearly 290 subsidiaries and other consolidated entities.

Alibaba's corporate structure, thus, is composed of multiple levels of ownership and its corporate network is extended both within the territory of China and in offshore jurisdictions; as mentioned before, the preferred jurisdictions for the incorporation of holding companies are the Caribbean tax havens Cayman Islands and BVI.

Alibaba is the largest and most successful e-commerce platform but it is relevant to notice that its worldwide success relies on a corporate structure that includes the VIE structure, which is an entity still surrounded by legal ambiguity under Chinese law. By adopting VIEs, Alibaba's corporate structure had been designed with the specific purpose of avoiding Chinese restrictions on foreign investment in the internet sector.

In the SEC Form F-1, in the section “Contractual Arrangements among Our Wholly-Foreign Owned Enterprises, Variable Interest Entities and the Variable Interest Entity Equity Holders”, in fact, it is expressly stated that:

> Due to PRC legal restrictions on foreign ownership and investment in, among other areas, value-added telecommunications services, which include the operations of Internet content providers, or ICPs, we, similar to all other entities with foreign-incorporated holding company structures operating in our industry in China, operate our Internet businesses and other businesses in which foreign investment is restricted or prohibited in the PRC through wholly foreign owned enterprises, majority-owned entities and variable interest entities. The relevant variable interest entities, which are incorporated in the PRC and 100% owned by PRC citizens or by PRC entities owned by PRC citizens, where applicable, hold the ICP licenses and

> other regulated licenses and operate our Internet businesses and other businesses in which foreign investment is restricted or prohibited.[86]

The legal ambiguity of the VIE structure under Chinese law was clearly understood by Alibaba; indeed, in the Registration Statement filed prior to the IPO on the US stock exchange it was included the following statement:

> If the PRC government deems that the contractual arrangements in relation to our variable interest entities do not comply with PRC governmental restrictions on foreign investment, or if these regulations or the interpretation of existing regulations changes in the future, we could be subject to penalties or be forced to relinquish our interests in those operations.[87]

The uncertainty of the legal status of the VIE under Chinese law is therefore a risk that Alibaba has acknowledged; and it is significant that such statement was included in its SEC Registration Statement, in order to serve as a warning for the company's investors.

As mentioned before, Alibaba's VIE structure includes an entity incorporated in the Cayman Islands, which is the listing vehicle that held the IPO on the NYSE. The VIE structure, hence, raised questions on the Alibaba IPO and on the risks for investors that bought Alibaba shares.

In fact, investors that have bought Alibaba shares listed on the NYSE do not actually have title to Alibaba's Chinese assets: this is because, due to the structure of the VIE, they have actually bought shares of the shell company used as listing vehicle and incorporated in the Cayman Islands which, according to contractual agreements, receives profits from Alibaba's operating Chinese assets, but does not actually own them[88]. Indeed, the contractual agreements between the offshore holding company, the WFOE and the Chinese operating company simulate equity ownership, but in reality

86 Alibaba Group Holding Ltd., *Registration Statement (Form F-1)*, http://otp.investis.com/clients/us/alibaba/SEC/sec-show.aspx?FilingId=10205127&Cik=0001577552&Type=PDF&hasPdf=1, accessed 2/04/2017.

87 Alibaba Group Holding Ltd., *Registration Statement (Form F-1)*, http://otp.investis.com/clients/us/alibaba/SEC/sec-show.aspx?FilingId=10205127&Cik=0001577552&Type=PDF&hasPdf=1, accessed 2/04/2017.

88 KITCHEN, Michael (2014), *Beware: Alibaba IPO isn't Really Selling Alibaba*, http://www.marketwatch.com/story/beware-alibaba-ipo-isnt-really-selling-alibaba-2014-05-07, accessed 4/04/2017.

they do not give actual equity ownership in the operating business (Johnson 2015: 253).

However, Alibaba claimed that it has minimized the use of the VIE structure to the greater extent possible; in fact, in its SEC Registration Statement, Alibaba precisely stated that:

> Other than the ICP licenses and other licenses and approvals for businesses in which foreign ownership is restricted or prohibited held by our variable interest entities, we hold our material assets in, and conduct our material operations through, our wholly-foreign owned and majority-owned enterprises (…). We generate the significant majority of our revenue directly through our wholly foreign owned enterprises, which directly capture the profits and associated cash flow from operations without having to rely on contractual arrangements to transfer such cash flow from the variable interest entities to the wholly-foreign owned enterprises.[89]

2.6 Draft Foreign Investment Law

In January 2015, the MOFCOM published a draft version of a new law intended to regulate foreign investment in China, named People's Republic of China Foreign Investment Law (Draft for Comments) (中华人民共和国外国投资法-草案征求意见稿）Zhonghua Renmin Gongheguo Waiguo Touzi Fa - Cao'an Zhengqiu Yijian Gao). This law, once becomes effective, will replace the existing laws governing FIEs, that are EJV Law, CJV Law and WFOE Law, and will become the basic law governing all foreign investment activities in China. In this way, it will unify the legal regime regulating FIEs, that has always comprised several distinct laws and regulations, which have often resulted fragmentary and inconsistent, and have always given the opportunity to investors to exploit the legal loopholes in it.

The major reform that the Draft Law wishes to introduce is that foreign investments are no longer regulated by a specific law depending on the legal business form of its incorporation; that is, there is no longer the distinction between EJV, regulated by the EJV Law, CJV, regulated by CJV Law, and WFOE, regulated by WFOE Law. In particular, the WFOE won't be considered as a specific form of business vehicle.

89 Alibaba Group Holding Ltd., *Registration Statement (Form F-1)*, http://otp.investis.com/clients/us/alibaba/SEC/sec-show.aspx?FilingId=10205127&Cik=0001577552&Type=PDF&hasPdf=1, accessed 2/04/2017.

Moreover, one of the major reform is included in Article 11[90], which broadened the definition of foreign investors and introduced the concept of actual control:

> For the purpose of the Law, the term "foreign investors" refers to the following parties who make investments within the territory of China: natural persons without Chinese nationality; enterprises incorporated in accordance with laws of other countries or regions; governments of other countries or regions and their subordinate departments or agencies and international organizations.
> Domestic enterprises controlled by the parties prescribed in the preceding paragraph shall be deemed as foreign investors.[91]

The implication is that, according to the Draft Law, also a Chinese subsidiary controlled by foreign investors has to be treated as a foreign investor itself.

As a consequence, under the principle of "actual control", foreign investment undertaken using a VIE with the purpose of circumventing the restrictions on foreign shareholding in Chinese companies will be prohibited by law; under the Draft Law, in fact, VIEs are treated as foreign investment and consequently are subject to the same regulations.

Provisions regarding VIEs on one hand contrast actual foreign investors that are using VIE structures with the specific purpose of circumventing restrictions, on the other hand do not impede VIE structures in which Chinese nationals have the actual controlling interest[92]. Under the new provisions, foreign entrepreneurs won't be able to use a VIE structure in order to obtain a controlling interest in a business operating in a prohibited industry, and also foreign financial investors, for example private equity

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90 Original version in Chinese language: "本法所称的外国投资者，是指在中国境内投资的以下主体：不具有中国国籍的自然；依据其他国家或者地区法律设立的企业；其他国家或者地区政府及其所属部门或机构；国际组织。受前款规定的主体控制的境内企业，视同外国投资者 (Benfa suocheng de waiguo touzizhe, shi zhi zai Zhongguo jingnei touzi de yixia zhuti: bu juyou Zhongguo guoji de ziran; yiju qita guojia huozhe diqu falü sheli de qiye; qita guojia huozhe diqu zhengfu ji qi suoshu bumen huo jigou; guoji zuzhi. Shou qian kuan guiding de zhuti kongzhi de jingnei qiye, shitong waiguo touzizhe)", Zhonghua renmin gongheguo shangwubu 中华人民共和国商务部（2015）， Zhonghua renmin gongheguo waiguo touzi fa (cao'an zhengqiu yijian gao) 中华人民共和国外国投资法（草案征求意见稿）, http://tfs.mofcom.gov.cn/article/as/201501/20150100871010.shtml, accessed 31/03/2017.

91 Foreign Investment Law (Draft for Comments) (2015), http://english.mofcom.gov.cn/article/policyrelease/Cocoon/201501/20150100875221.shtml, accessed 28/03/2017.

92 TAM, GE, LIU, (2015), *Draft Foreign Investment Law: Fundamental Changes to Foreign Investment Regime in China*, https://www.mayerbrown.com/files/Publication/c7e56576-38b5-4ed3-8e2c-4b07e1df01bb/Presentation/PublicationAttachment/aa023dbe-b0c0-4244-ba86-538b3e6647e1/150128-PRC-Draft-ForeignInvestmentLaw.pdf, accessed 28/03/2017.

investors and venture capital investors, won't be able to obtain any interest, even a minority interest, in a Chinese business operating in a prohibited industry (Chapman 2016: 12).

The Draft Law governs all foreign investment activities in China, and refers not only to non-resident investors, including both foreign nationals and companies incorporated outside China, but also domestic companies under the actual control of those foreign investors. The definition provided by the Law comprises two structures which are currently used in China by foreign investors with the purpose of structuring certain specific transactions: the second-level foreign invested company, that is, a company controlled by another company which is in turn invested by a foreign investor; and the VIE structure, that is, an entity controlled by a foreign investor through contractual arrangements.[93]

In detail, according to Article 15 of the Draft Law, the broader definition of the term foreign investment includes different types of investment activities conducted, directly or indirectly, by foreign investors. Activities mentioned in the Article include the establishment of domestic enterprises; the acquisition of equity, shares, shares of property, voting rights or other rights or interests of domestic enterprises; the provision of financing for a period longer than one year to a domestic enterprise in which foreign investors hold the equities prescribed above; the obtainment of concession rights relating to exploration or development of natural resources or relating to infrastructure projects in China; the acquirement of real estate rights such as the right to use land, housing ownership or other rights to immovable property in China; and

> controlling any domestic enterprise or holding interests in any domestic enterprise by contract, trust or other means.[94]

93 SHENG, LIVDAHL, SIU, (2015), *China Issues Draft Foreign Investment Law*, https://www.pillsburylaw.com/en/news-and-insights/china-issues-draft-foreign-investment-law.html, accessed 28/03/2017.

94 Foreign Investment Law (Draft for Comments) (2015), http://english.mofcom.gov.cn/article/policyrelease/Cocoon/201501/20150100875221.shtml, accessed 28/03/2017. Original version in Chinese language: "通过合同、信托等方式控制境内企业或者持有境内企业权益 (Tongguo hetong, xintuo deng fangshi kongzhi jingnei qiye huozhe chiyou jingnei qiye quanyi)", Zhonghua renmin gongheguo shangwubu 中华人民共和国商务部 （2015），Zhonghua renmin gongheguo waiguo touzi fa (cao'an zhengqiu yijian gao) 中华人民共和国外国投资法（草案征求意见稿）, http://tfs.mofcom.gov.cn/article/as/201501/20150100871010.shtml, accessed 28/03/2017.

The last provision specifically refers to the VIE structure, and treats it as foreign investment; in this way, it addresses the use of VIEs with the purpose of circumventing restrictions for foreign investment in specific industries: in fact, the nationality of the ultimate controlling owner will effectively determine the nature of a VIE entity.

Hence, the Draft Law includes in the definition of foreign investment also domestic enterprises under actual control of non-Chinese investors; investments undertaken by these enterprises, thus, are treated as foreign investment, not domestic ones, and consequently are regulated by the Foreign Investment Law.

Moreover, according to the Draft Law, an offshore transaction is considered foreign investment in the case that such operation is resulting in the acquisition of control of a domestic enterprise by a foreign investor.

The control of a company, as defined by Article 18 of the Draft Law, includes both the direct or indirect ownership of more than 50% of the shares, equity, shares in property, voting rights or other similar rights and interests in the enterprise; and the ownership of less than 50% of the shares or voting rights in the case that the investors has in fact the direct or indirect control over the decision-making body of the company, and is

> […] able to impose decisive impacts on the operation, finance, personnel or technology, etc. of the enterprise by contract, trust or other means.[95]

In this way the Draft Law, by broading the definition of foreign investors and the cases in which an investment falls under the definition of foreign investment, actually reduced the possibility for foreign investors to move capital in and out of China through the use of various type of holding structures and ownership chains.

The main issues covered by the Draft Law, in addition to the broadening of the definition of foreign investor and foreign investment and the abrogation of the existing

95 Foreign Investment Law (Draft for Comments) (2015), http://english.mofcom.gov.cn/article/policyrelease/Cocoon/201501/20150100875221.shtml, accessed 28/03/2017. Original version in Chinese language: "通过合同、信托等方式能够对该企业的经营、财务、人事或技术等施加决定性影响的 (Tongguo hetong, xintuo deng fangshi nenggou dui gai qiye de jingying, caiwu, renshi huo jishu deng shijia juedingxing yingxiang de)", Zhonghua renmin gongheguo shangwubu 中华人民共和国商务部 （2015）, Zhonghua renmin gongheguo waiguo touzi fa (cao'an zhengqiu yijian gao) 中华人民共和国外国投资法（草案征求意见稿）, http://tfs.mofcom.gov.cn/article/as/201501/20150100871010.shtml, accessed 28/03/2017.

three laws governing FIEs, include other relevant aspects.

According to the existing regulation, any foreign investment in China, both in the case of establishment of a new company or acquisition of an existing company, must obtain the approval from MOFCOM or its local branch before registration.

By contrast, under the Draft Law, only investment in restricted sectors, included in a Negative List[96] that was issued in October 2016 by the State Council, and which replaced the existing Catalogue, or investment that exceed a fixed monetary limit, require government approval; whereas any other investment is subject to national treatment in terms of market entry and can directly obtain the business license. As a consequence, foreign investment projects will enjoy a greater flexibility.

The consequences of the Draft Law are broad, the provisions that it introduces have effects on two levels: on one hand, the introduction of general and unified standards restricts the discretions and the ambiguity of the previous legislations, which have always left a wide margin of interpretation and have allowed both Chinese and foreign investors to exploit loopholes in the regulatory regime; on the other hand, it eliminates the fiction, from a legal point of view, that a domestic entity controlled by foreign investors is not itself a foreign investment (Chapman 2016: 13).

Thus, provided that the VIE structure is treated as foreign investment under the Draft Law, its adoption in restricted industry sectors would expressly violate the restrictions imposed on foreign investment and therefore would be illegal under Chinese law.

Article 149 of the Draft Law also proposes the application of penalties on foreign investors and foreign-invested enterprises that make investment in prohibited or restricted sectors circumventing Chinese foreign investment restrictions by using entrusted holding, trust, multi-level re-investment, leasing, contracting, financing arrangements, protocol control, overseas transactions or other means.[97]

96 The Negative List includes two categories: prohibited industries and restricted industries; there are two types of restrictions imposed on foreign investment in restricted sectors: investment exceeding a certain monetary limit, set by the State Council, and investment in restricted areas. Also the impact on national security will be object of review.

97 Foreign Investment Law (Draft for Comments) (2015), http://english.mofcom.gov.cn/article/policyrelease/Cocoon/201501/20150100875221.shtml, accessed 28/03/2017. Original version in Chinese language: "外国投资者、外国投资企业以代持、信托、多层次再投资、租赁、承包、融资安排、协议控制、境外交易或其他任何方式规避本法规定，在

The Draft Law, however, hasn't been adopted yet.

2.7 Decision and Record-filing Measures

On 3 September 2016, the National People's Congress approved the Decision to Amend Four Laws Including the Wholly Foreign-Owned Enterprise Law of the People's Republic of China (关于修改《中华人民共和国外资企业法》等四部法律的决定 Guanyu xiugai "Zhonghua renmin gongheguo waizi qiye fa" deng si bu falu de jueding), also referred to as the Decision, which took effect on 1st October 2016. The Decision modified the existing law regulating foreign investment in China applied to FIEs, and substantially changed the regime governing foreign investment in China that has been applied since 2000. It was issued a Negative List, which includes sectors in which the approval of MOFCOM is required for foreign investment. With regard to industry sectors not included in the List, the foreign investments are subject to national treatment, and hence do not need the MOFCOM approval but are required only to file limited information with MOFCOM.

Also with regard to M&A deals, the MOFCOM approval for the acquisition of FIEs not operating in sectors included in the Negative List is no longer required; however, the acquisition of Chinese domestic enterprises is still regulated under the M&A Rules.[98]

On 8 October 2016 MOFCOM released the Interim Measures on Record-filing and Management of Establishment and Amendment of Foreign-Invested Enterprises (外商投资企业设立及变更备案管理暂行办法 Waishang touzi qiye sheli ji biangeng bei'an guanli zanxing banfa), Record-filing Measures, which is a temporary

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禁止实施目录列明的领域投资、未经许可在限制实施目录列明的领域投资或违反本法规定的信息报告义务的（…）进行处罚 (Waiguo touzizhe, waiguo touzi qiye yi daichi, xintuo, duoceng ci zai touzi, zulin, chengbao,rongzi anpai, xieyi kongzhi, jingwai jiaoyi huo qita renhe fangshi guibi ben fa guiding, zai jinzhi shishi mulu lieming de lingyu touzi, wei jing xuke zai xianzhi shishi mulu lieming de lingyu touzi huo weifan ben fa guiding de xinxi baogao yiwu de (…) jinxing chufa)", Zhonghua renmin gongheguo shangwubu 中华人民共和国商务部 （2015）， Zhonghua renmin gongheguo waiguo touzi fa (cao'an zhengqiu yijian gao) 中华人民共和国外国投资法（草案征求意见稿）, http://tfs.mofcom.gov.cn/article/as/201501/20150100871010.shtml, accessed 28/03/2017.

98 FENG, Judy YAN, Wendy (2016), *A New Era of China's Foreign Investment Regime*, https://www.faegrebd.com/a-new-era-of-chinas-foreign-investment-regime, accessed 5/04/2017.

arrangement regarding the implementation of procedures for filing with the MOFCOM.

The Decision actually implemented some of the provisions included in the Draft Law, such the release of the Negative List, the national treatment for foreign investors under some circumstances and the mechanism for sharing and reporting information. However, under the Decision it is not specifically addressed the structure and the legal validity of VIEs, that was covered by the Draft Law.[99]

99 Practical Law China (2016), *MOFCOM Finalises FIE Record-filing Measures*, https://uk.practicallaw.thomsonreuters.com/w-003-9184?__lrTS=20170406084757864&transitionType=Default&contextData=(sc.Default), accessed 5/04/2017.

Chapter 3
China's Most Used Tax Havens

3.1 Cayman Islands

The Cayman Islands is a British Overseas Territory in the Caribbean Sea; it is a common-law jurisdiction and it consists in three islands, Grand Cayman, Cayman Brac and Little Cayman. The territory is responsible for its own self-government, whereas the United Kingdom is responsible for external affairs, defense and the courts; it has an independent legal and judicial system based on English common law. The territory of Cayman Islands covers 240 km²; by 2015, its population was 0,060 million people, the GDP was $3,446 million and the GDP per capita $57,458 million.

The Cayman Islands has no significant natural resources or the possibility to develop a flourish industry or agriculture, so it has always relied upon its attractivity for tourists and, in a second moment, for offshore finance. Specifically, its status as tax havens had started to develop in the 1960s, when the first international banks started to establish offshore branches there.

Cayman Islands is a well-known no-tax jurisdiction, because it imposes taxes on imports and sales taxes, but there are no income, capital gains and inheritance taxes;[100] it also has provisions which ensure banking secrecy and confidentiality: in fact, its legislation protects all information regarding business of a professional nature undertaken within the territory and, as it is a common law jurisdiction, it also protects information communicated in confidence, or in any other circumstances that actually create an obligation of confidence.[101] These provisions could hypothetically be applied to every kind of information regarding every type of business within the territory. These features, together with a ring-fencing if its regime, make it one of the largest and most successful tax haven of the world.

A stock exchange, the Cayman Islands Stock Exchange (CSX), was opened in

100 The inheritance tax is the tax imposed on the assets inherited from a deceased person.

101 Cayman Islands: Guide to Doing Business, http://www.lexmundi.com/lexmundi/Guides_To_Doing_Business.asp, accessed 5/03/2017.

1997:[102] it was a relatively small exchange, owned by the government, whose primary activity was listings, while trading on this exchange was infrequent. However, CSX has been a really fast growing exchange; it was established in order to allow primarily the listing of offshore mutual funds and specialist debt securities. Its main focus is towards international capital markets and it provides an efficient and sophisticated listing regime; CSX listing rules conform to international standards, and it is officially recognized by international institutions and global major market players.

Numerous world leading financial institutions have listed their financial products on CSX, and exempted companies incorporated in the Cayman Islands are allowed to use the CSX for raising capital and trading securities.[103] By 2009, according to the data provided by the Cayman Islands Monetary Authority, there were 1,575 listings, including 794 mutual funds, 714 specialized debt instruments, in particular asset-backed securities[104] and other structured debt, and 5 equity listings. In 2006 it was traded $1.6 million, in 2007 $5.8 million and $1.4 million in 2008; also in 2008, there were 80 trades involving 359,431 shares (IMF 2009: 15).

By 1972, within the Cayman Islands were already present more than 3,000 registered companies, and more than 300 trust companies; by 1993 there were established nearly 25,000 companies, of which 55% were merely shell entities, and there were registered 532 banks, whose 80% were shell branches with no physical presence (Roberts 1995).

Throughout the years, the number of entities established in Cayman Islands increased steadily and remarkably, due to the increasing importance they gained in the context of offshore finance. By 2007, the number of International Business Companies (IBCs) reached 62,000 units and there were 740 captive insurance companies established there; by 2008, there were 1,257 Cayman Islands International Companies, 989 Cayman Islands Asset Protection Trusts, and 620 Cayman Exempts were established (Caruana-Galizia, Caruana-Galizia 2016).

102 https://www.cia.gov/library/publications/the-world-factbook/geos/cj.html, accessed 5/03/2017.

103 http://www.applebyglobal.com/publication-pdf/guide/guide-to-companies-in-the-cayman-islands---january-2016.-2.pdf, accessed 5/03/2017.

104An asset-backed security is a financial security backed by assets such as loans, leases or receivables other than real estate; the underlying pool of assets is typically a group of small and illiquid assets that cannot be sold individually. For investors, it is an alternative to investing in corporate debt (source: http://www.investopedia.com/terms/a/asset-backedsecurity.asp, accessed 5/03/2017).

Also in 2008, the number of registered companies was more than 93,000, including nearly 300 banks, 800 insurers and 10,000 mutual funds.[105] By 2010, Cayman Islands still had 91,206 active companies registered within its jurisdiction, and only in 2010 registered 8,157 new companies (Vlcek 2013: 539).

According to estimates, at the end of 2006 the hedge fund assets held in Cayman Islands were $525.503 million (Sullivan 2007b); by 2007, all the banks registered in Cayman Islands collectively managed around $1.5 trillion in deposits. In 2014, the income booked in foreign affiliates registered within their territory reached remarkable levels, in particular if compared with the GDP of such a small location: it was estimated at $30 billion, which accounted for 874.9% of the domestic GDP (UNCTAD 2016: 22).

3.1.1 Economic Activity

The Cayman Islands has always based its economy on these dual pillars: tourism and financial and business services, by promoting and augmenting its role as tax haven. It focused on providing services such as the incorporation of offshore companies and trusts, in addition to the offshore banking service; captive insurance companies, offshore mutual funds, law and accountancy firms and a variety of other complex financial instruments are available within the territory.

The Cayman Islands, in fact, is considered one of the largest captive insurance domiciles in the world, and it is also the main domicile for the formation of SPVs (IMF 2009: 18). The insurance sector is also very large, and it is separated in two distinct segments: the domestic market and the international segment, which accounts for more than 99% of the total amount of assets managed by the industry, that is, approximatively $35 billion by 2009 (IMF 2009: 17).

The Cayman Islands always tried to emphasize the tax advantages and other benefits provided by its jurisdictions and, also, other attractive factors such as the secure and stable political and social environment due to its status of British Overseas Territory. It is a common-law jurisdiction, and its legal principles conform with those under English common law: this is another appealing feature for international investors,

105https://www.cia.gov/library/publications/the-world-factbook/geos/cj.html, accessed 5/03/2017.

because this kind of legislation is familiar to them and they feel more comfortable and secure in operating in such a context.

Moreover, Cayman Islands can enjoy an efficient and ease system of communication with the United States, a reliable telecommunication service, a light regulatory environment, with no foreign exchange controls, and a flexible corporate legislation (Roberts 1995: 240). Relying on these advantages, Cayman Islands has always tried to attract foreign investors, both in the form of corporations and individuals, which aim to exploit the benefits in locating offshore their transactions, business activities and wealth.

In recent years, the authorities in Cayman Islands are trying to implement international standards, also with regard to taxation, or at least they commit to it; the cooperation with international organizations, in particular with the OECD, and the commitment to share information is important for the territory to continue growing. Hence, in 2000 the Cayman Islands committed to implement international standards promoted by the OECD, agreeing to cooperate with such organization in contrasting harmful practices that lead to tax competition, and it also signed several agreements; however, regardless of the commitment, it has not yet substantially implemented such standards (Carbone, Bosco, Petese 2015).

3.1.2 Companies Law and Incorporation

Cayman Islands provides a wide range of financial services, but it is specialized in particular in the banking sector services; it is also a location for the incorporation of companies due to the favorable provisions of its law. The corporate legislation is regulated by the Companies Law, which has been amended several times throughout the years.

The companies incorporated in Cayman Islands can be either companies that operate in the domestic economy or companies that undertake business primarily outside the territory; the second type commonly takes the form of exempted company, which is the most common type of offshore company and is used for international business transactions. Exempted companies incorporated in the Cayman Islands usually

serve as investment vehicles and Special Purpose Vehicles (SPVs) in capital market transactions.

The two categories are severely distincted, and companies incorporated in the form of exempted companies are prohibited to carry on business within the domestic economy; in fact, as stated in sections 163 and 165 of the Companies Law:

> Any proposed company applying for registration under this Law, the objects of which are to be carried out mainly outside the Islands, may apply to be registered as an exempted company. […] A proposed exempted company applying for registration as an exempted company shall submit to the Registrar a declaration signed by a subscriber to the effect that the operation of the proposed exempted company will be conducted mainly outside the Islands.[106]

However, exempted companies are permitted to have a Cayman bank account, to maintain an office there and to effectively undertake all the necessary operations in order to carry on their business outside the territory. Section 174 of the Companies Law further specifies that

> An exempted company shall not trade in the Islands with any person, firm or corporation except in furtherance of the business of the exempted company carried on outside the Islands. Provided that nothing in this section shall be construed so as to prevent the exempted company effecting and concluding contracts in the Islands and exercising in the Islands all of its powers necessary for the carrying on of its business outside the Islands.[107]

This is what is called ring-fencing of regimes: the preferential regime applied to non-residents is partly or fully isolated from the domestic economy; in this way, the domestic market is not affected by the incentives offered by the country to non-resident investors. The need for a country to protect its domestic economy suggests that the preferential regimes are considered to be potentially harmful; this is one of the main criteria identified by the OECD in order to recognize tax havens and preferential tax regimes (OECD 1998).

As many other offshore jurisdictions, Cayman Islands imposes minimal fees for the incorporation of companies, and also insignificant annual fees have to be paid after

106Cayman Islands Companies Law, https://www.conyersdill.com/consolidated-acts/cayman-companies-act, accessed 10/03/2017.

107Cayman Islands Companies Law, https://www.conyersdill.com/consolidated-acts/cayman-companies-act, accessed 10/03/2017.

the incorporation; moreover, the time of incorporation requires between three and five business days only. These are other appealing features of Cayman Islands legislation which attract foreign investors in creating offshore entities there.

The provisions regarding incorporation and annual fees are contained in section 26 (4) of the Companies Law. In detail, the incorporation fee payable by a non-resident company with no registered capital, or a registered capital not exceeding $42,000, is $575, with a registered capital exceeding $42,000 is $815; the incorporation fee for an exempted company with no registered capital, or a registered capital not exceeding $42,000 is $600; with a registered capital exceeding $42,000 but not exceeding $820,000 is $900; with a registered capital exceeding $820,000 but not exceeding $1,640,000 is $1,884; with a registered capital exceeding $1,640,000 is $2,468. In respect of any other company with no registered capital or a registered capital not exceeding $42,000 the incorporation fee is $300, with a registered capital exceeding $42,000 is $500.

The annual fees payable by every company other than an exempted company is specified in section 41 (2) of the Companies Law as follows: in the case of a non-resident company the annual fee ranges between $675 and $915 depending on the registered capital; in the case of any other company the annual fee is between $300 and $500 depending on the registered capital. The annual fee payable by an exempted company is specified in section 169 (1) and ranges from a minimum of $700 to a maximum of $2,568 depending on the registered capital.

Moreover, Cayman Islands does not impose taxes on profits, income or dividends; there are no capital gains taxes, corporation taxes, or withholdings, estate or inheritance taxes. Under this jurisdiction, transactions such as dividends paid to foreign corporate shareholders, dividends received from foreign companies, interest paid to foreign corporate shareholders and intellectual property royalties paid to foreign corporate shareholder are not taxable.[108]

Also, in the Companies Law there are no general requirements for securing audited financial statements, but certain categories of companies which require licenses to conduct their business, such as insurance companies, are required to file audited

108Cayman Islands: Guide to Doing Business, http://www.lexmundi.com/lexmundi/Guides_To_Doing_Business.asp, accessed 6/03/2017.

accounts.

3.1.3 Banking Sector

As mentioned above, the economy of the Cayman Islands primarily relies upon tourism and offshore finance. The banking sector is very large compared to the size of the domestic economy: it is considered the fifth largest financial center in the world, and it manages around $1.75 trillion in assets; however, more than $1 trillion of these assets consists of "sweep" accounts[109] held in branches of US banks.

Other financial activities in the jurisdiction involve booking claims through Cayman branches, raising funds for the parent bank or other companies within the group and providing other offshore services, which are primarily intended for the use of corporations.

It is relevant to point out the fact that a great part of the licensed banks in the Cayman Islands are merely branches with no physical presence in the territory, and that only a little proportion of them is intended to serve the local population: by 2009, 208 banks out of 278 licensed ones had no presence there, and only 7 provided services to the residents. These banks, both the ones with physical presence and those without any presence, provide a wide range of financial services to both individuals and corporations (IMF 2009: 11).

According to data provided by the Cayman Islands Monetary Authority, in 2005 there were 301 licensed banks, which collectively managed $1,247,383 million; in the following years, the number of banks registered a little decrease, but the total assets managed there remarkably increased: in 2006 there were 291 banks, managing $1,650,265 million in assets, in 2007 there were 281 banks managing $1,922,041 million, and in 2008 there were 278 banks managing $1,754,121 million assets (IMF 2009: 11).

109A sweep account is a bank account that automatically transfers amounts that exceed, or is below, a certain level into a higher interest-earning investment option at the close of each business day with the purpose of earning higher returns on cash (source: http://www.investopedia.com/terms/s/sweepaccount.asp, accessed 5/03/2017).

3.1.4 FDI Flows

As mentioned before the Cayman Islands implements a preferential regime with regard to taxation with the specific purpose of attracting non-resident capital; it also provides a wide range of financial services, and it offers itself as a favorable offshore location for routing capital, investment and booking transactions, and throughout the years the capital flows in and out the jurisdiction has been consistent.

It is provided the evidence of the prominent role played by Cayman Islands as tax haven if comparing the size of its financial sector and the small size of the domestic economy: the activities in Cayman Islands financial sector far exceed the domestic financial needs, and this is due to the bulk of services specifically offered to non-residents. This is another characteristic feature which most commonly indicates the status of tax haven and OFCs.

The disproportion is evident when comparing the FDI flow in and out the jurisdiction with the domestic GDP, as shown in Table 1. The Table shows the FDI inflows and outflows between 2000 and 2015, and makes a comparison between the amount of capital flow and the domestic GDP year by year; it also indicates the amount of FDI inflows and outflows as a percentage of the global amount of FDI per year.

Table 1. Cayman Islands Data

Year	Inward FDI Flow (in billion)	Percentage of total world	Percentage of domestic GDP	Outward FDI flow (in billion)	Percentage of total world	Percentage of domestic GDP
2000	$7.627	0.5%	334%	$7.239	0.6%	317%
2001	$3.923	0.5%	167%	$6.425	1.1%	275%
2002	– $196	– 0.03%	– 8.04%	– $4.799	– 0.9%	– 197%
2003	– $2.689	– 0.4%	– 106%	$5.300	1.0%	209%
2004	$9.669	1.4%	363%	$4.918	0.5%	184%
2005	$10.221	1.1%	336%	$2.828	0.3%	92%
2006	$14.963	1.1%	466%	$7.950	0.5%	247%
2007	$23.218	1.2%	660%	$7.999	0.3%	227%

2008	$19.634	1.3%	553%	$14.090	0.8%	397%
2009	$20.426	1.7%	612%	$8.230	0.7%	246%
2010	$11.948	0.8%	365%	$9.400	0.6%	287%
2011	$19.026	1.2%	568%	$6.971	0.4%	208%
2012	$8.104	0.5%	237%	$3.222	0.2%	94%
2013	$18.176	1.2%	521%	$11.029	0.8%	316%
2014	$23.731	1.8%	681%	$8.738	0.6%	251%
2015	$18.987	1.1%	551%	$8.273	0.5%	240%

(Source: UNCTAD Statistics, http://unctadstat.unctad.org).

3.1.5 Relationship with China

The Cayman Islands not only plays a major role in the global capital flows and in the investment inflows and outflows of countries all over the world, but also it is relevant to notice the tight relationship it has with China with regard to investment flows. There is a consistent body of literature on the role that offshore jurisdictions play in Chinese FDI, and numerous scholars addressed the issue.

As mentioned before, the Cayman Islands is the main recipient of China's outward FDI and is also a source of consistent inward FDI within China: in 2003, it received around 28.3% of China's outward investment, and the percentage reached 44% in 2006; also, it accounted for 3.2% and 3.4% of investment inflows into China in 2005 and 2006 respectively. On the whole, by 2006, Cayman Islands and BVI accounted for 47.5% of the total amount of Chinese outward investment flows (Sutherland, Matthews 2009).

In terms of value, the amount of FDI from Cayman Islands directed into China was consistent throughout the years, even if it did not reach the amount originating from the other Caribbean tax haven BVI. In 2000, FDI into China originated in Cayman Islands accounted for $623.73 million, in 2001 $1,066.71 million, and in 2002 $ 1,179.54 million; the FDI flow registered a decrease in 2003, when was estimated at $866.04 million, and then peaked in 2004, reaching $2,042.58 million. In 2005, the FDI flow remained consistent, and accounted for $1,947.54 million.

Cayman Islands not only has been one of the major sources of FDI directed into China, but has also been one of the major destinations of Chinese FDI: the amount of

FDI flows between Cayman Islands and China remained considerable throughout the years, even if it is possible to notice that, since 2009, the magnitude of investment from the Caribbean jurisdiction registered a slight but constant decline. The amount of inward FDI originated from Cayman Islands and the amount of Chinese outward FDI directed towards the same destination in the last years are shown in Table 3.

Table 3. Cayman Islands-China FDI Statistics

	Chinese Inward FDI from Cayman Islands (in million)	Chinese FDI to Cayman Islands (in million)
2006	$2,095.46	$7,832.72
2007	$2,570.78	$2,601.59
2008	$3,144.97	$1,524.01
2009	$2,581.89	$5,366.30
2010	$2,498.80	$3,496.13
2011	$2,241.96	$4,936.46
2012	$1,975.40	$827.43
2013	$1,668.25	$9,253.40
2014	$1,225.09	$4,191.72
2015	$1,444.6	$10,213.03

(Source: National Bureau of Statistics of China, http://www.stats.gov.cn/english/Statisticaldata/AnnualData/).

The favorable taxation system in this jurisdiction, which offers low or zero taxes on income and capital gains, is attractive for foreign investors and also for Chinese ones. However, there are other legal, practical and commercial factors underlying its attractivity for Chinese enterprises.

The main reason underlying the choice of Cayman Islands, rather than other tax havens or OFCs offering the same incentives, is the fact that it has a high quality commercial law and it specialized in business related to financial services and offers sophisticated investment and capital markets products; in fact, the financial sector relies upon a sophisticated and developed service provider structure, and is composed by

experts and professionals. The legal and the accounting sectors, in particular, are specialized in structuring and supporting investment activities and services in the securities sector, and they offer a high degree of professionalism (IMF 2009: 15).

Apart from the professionalism of the service providers, the attractivity of the Cayman Islands for investors is due to the presence of a great proportion of the major international banks, which provide offshore services to corporations and individuals; as previously mentioned, the Cayman Islands is considered to rank within the ten major international banking centers and, according to different estimates, the assets managed there range between $1.5 trillion and $1.75 trillion (IMF 2009: 10; Sutherland, El-Gohari, Buckley, Voss 2010: 19).

3.1.6 Listing

As mentioned before, due to its sophisticated and well developed financial sector, the Cayman Islands is commonly used by Chinese enterprises to overcome the imperfections in China's financial and legal environment and to overcome structural inefficiencies.

The Cayman Islands offers a secure legal environment for structuring investment and an internationally accepted platform for fund raising, allowing Chinese enterprises to access international capital. Hence, it is the favorite place of incorporation for Chinese listing vehicles, in particular with the purpose of accessing international capital markets. By accessing foreign capital markets through the use of offshore entities, in fact, Chinese enterprises circumvent the constraints of domestic capital markets and are able to raise finance through an IPO listing on international capital markets (Wilson 2014: 218).

The main advantage of incorporating a listing vehicle in the Cayman Islands is the fact that it can then be listed on several stock exchanges, including both Hong Kong and US ones; this allows the listing vehicle to access the markets that offer the highest valuation and, in doing so, maximizing the firm's value. Many Chinese technology and internet companies listed on US stock exchanges are, in fact, Cayman Islands companies. The simplest organizational structure includes a Cayman Islands holding

company, which receive the investment, and a Chinese subsidiary, which is the operating company.

The preference of Cayman Islands over other tax havens is due to the restrictions imposed in other jurisdictions: as an example, a BVI listing vehicle cannot access such stock exchanges (Sutherland, El-Gohari, Buckley, Voss 2010: 19): on the HKEX are allowed to be listed only Hong Kong, China, Cayman Islands and Bermuda companies, while BVI and US companies are not approved.

The importance of incorporate a listing vehicle in a jurisdiction approved by the Hong Kong listing rules is due to the greater importance of such exchange for Chinese firms; in particular, after the implementation in 2002 of the Sarbanes-Oxley Act,[110] which imposed stricter requirements for companies listed on US stock exchanges, the greater majority of IPOs held by Chinese firms were made on the HKEX. The shift of preference towards listings on HKEX rather than on US stock exchanges is due not only to the higher cost of complying with such requirements, but is also due to the economic size needed to undertake an IPO on the NASDAQ. Also, an increasingly attractive factor is the improved liquidity of HKEX and its greater proximity to China, which is the primary market of the businesses for Chinese listed firms.

Due to the tight control that the Chinese government imposes on the transit of capital into and from China, usually a government approval is required before the investment of capital in Chinese enterprises occurs and the movement of funds outside China takes place. The use of a company incorporated in the Cayman Islands also helps circumventing such restrictions: usually the offshore entity receives the investment and then finances the Chinese subsidiary, in this way the proceeds of the investment stay outside China as long as possible. Also, the offshore entity may receive directly the payments made by foreign customers for the sale of goods and services, so that, again, the proceeds remain into the offshore location as long as possible and the enterprise

110The Serbanes-Oxley Act was enacted on 30 July 2002 and was aimed at protecting investors by improving the accuracy and reliability of corporate disclosures. It introduces major changes to the regulation of financial practice and corporate governance, and it enhance financial disclosure. It applies to all publically held American companies, any international company that have registered equity or debt securities with the US Security and Exchange Commission (SEC), and any accounting firm or other third party that provides financial services to the previously mentioned companies, and its application is mandatory (source: https://www.sec.gov/about/laws/soa2002.pdf, accessed 13/03/2017).

enjoys greater flexibility in its operating (Greguras, Bassett, Zhang 2008).

3.1.7 The Case of Suntech and Fuwei Films

A representative example of the process through which Chinese companies establish their offshore corporate structure is the case of Suntech Power, a company engaged in the development and manufacturing of photovoltaic cells, which was first incorporated in China in 2001 under the name of Suntech China.

After the incorporation in China, in 2005 it registered a holding company in the BVI named Power Solar System Co. Ltd., or Suntech BVI, with the purpose of raising capital outside China relying upon foreign investors. Suntech BVI, then, undertook a series of transactions, which have been accounted for as recapitalization,[111] in order to acquire all the equity interests in Suntech China; before its IPO, in 2005 it incorporated another company in the Cayman Islands, Suntech Power Holdings Co. Ltd., or Suntech, to serve as listing vehicle.

Suntech became Suntech China's ultimate holding company when it issued shares to the existing shareholders of Suntech BVI in exchange for all of the shares they held in Suntech BVI; after these transactions, Suntech held an IPO on the NYSE in 2005, raising $321.8 million.[112]

It is possible to notice that the temporal sequence of the incorporation and the formation of the subsidiary is the opposite of what is shown in the organizational chart of the company, in which the company incorporated in Cayman Islands is placed at the top and the company's consequent operations are supposed to originate from it. This is the typical sequence followed by Chinese private companies when they decide to list on foreign stock markets in order to raise capital.

The establishment of offshore holding structures and listing vehicles allows

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111 The recapitalization is the restructuring of a company's debt and equity mixture, often with the aim of making a company's capital structure more stable or optimal. Basically, the process involves the exchange of one form of financing for another, such as removing preferred shares from the company's capital structure and replacing them with bonds (source: http://www.investopedia.com/terms/r/recapitalization.asp, accessed 5/04/2017).

112 Suntech Power has been one of the world's largest producer of solar panels until 2011, with a remarkably peak in its business in 2008; however, in March 2013 it announced a $541 million bond payment default, and it declared bankrupt (source: http://www.nytimes.com/2013/03/21/business/energy-environment/suntech-declares-bankruptcy-china-says.html, accessed 13/03/2017).

Chinese companies to raise capital also in several other ways, and the fund raising realized outside China permits these companies to further expand their business inside China (Sutherland, El-Gohari, Buckley, Voss 2010); in many cases, it would not be possible, or it would be more difficult, to successfully finance the development without operations conducted offshore.

The common offshore structure, in its simplest form, involves a holding company incorporated in the Cayman Islands, which holds a BVI subsidiary that, in turn, holds the Chinese subsidiary. By means of this ownership structure, the Chinese subsidiary is indirectly controlled by the ultimate owner through various levels of ownership. The Cayman Islands holding company receives the investment, while the Chinese subsidiary is the operating company. This organizational structure is very common and it is implemented by several companies; also, it is common the structuring of more complex entities, which are realized by adding various layers inside the basic structure presented above.

As an example of the implementation of the simplest configuration, it is possible to mention Fuwei Films: its offshore organizational structure involves a holding company, Fuwei Films (Holding) Co., Ltd. ("Fuwei Films"), incorporated in the Cayman Islands in 2004, which owns Fuwei Films (BVI) Co., Ltd., incorporated in the BVI; the latter then holds the Chinese subsidiary, Fuwei Films (Shandong) Co., Ltd., located within China (Sutherland, Matthews 2009: 14). Fuwei Films conducts its business operations through its wholly owned Chinese subsidiary.[113]

However, there are also other more complex structures, which involve several levels of BVI intermediaries and more elaborate ownership systems, including both equity ownership and contractual arrangements; the resulting structure hence is composed by several layers of holding companies and subsidiaries, connected with various type of contracts and agreements.

3.2 British Virgin Islands (BVI)

Just like the Cayman Islands, the BVI is a British Overseas Territory in the

113http://www.fuweiholdings.com/cn/about.aspx, accessed 5/03/2017.

Caribbean Sea and is a common-law jurisdiction. The government within the territory is fully responsible for all domestic laws and law enforcement, and raises its own revenue. The United Kingdom is only responsible for external affairs, defense and the courts. The two main industries of BVI are tourism and financial services. It is a small territory, with a land area of only 150 km², but prosperous, and it enjoys a high standard of living: by 2015, the estimated GDP was $930 million, and the GDP per capita $30,880 million.

The history of BVI and the development of its status of tax haven is similar to the history of the other important Caribbean havens, the Cayman Islands: they both have no significant resources and they didn't have the possibility to develop a flourish industry or agriculture. They have always relied on the attractivity of their location for tourists, and they have tried to exploit the sector of offshore finance by offering and developing a wide range of financial services and professionals, which are directed in particular to non-residents.

The most renewed characteristic of the BVI is the favorable taxation system; it is known as a no-tax jurisdiction, because it does not impose income, corporate or withholding taxes. This is also the basic feature that makes BVI appear in the list of tax havens of the world.

In detail, with regard to companies incorporated under its jurisdiction, section 242 (1) and (2) of the BVI Business Companies Act states that:

> [...] a company, all dividends, interest, rents, royalties, compensations and other amounts paid by a company and capital gains realized with respect to any shares, debt obligations or other securities of a company are exempt from all provisions of the Income Tax Ordinance. No estate, inheritance, succession or gift tax is payable with respect to any shares, debt obligations or other securities of a company.[114]

In addition to a low tax rate, BVI also offers a light regulated environment, a flexible corporate legislation and it ensures banking secrecy and confidentiality. An important feature, which it shares with the Cayman Islands, is the secure and stable political and business environment in the jurisdiction, due to its status of British Overseas Territory; moreover, the legal principles of the common law, in line with those under English common law, provide a familiar legislation in which international

114BVI Business Companies Act, 2004, http://www.bvifsc.vg/Portals/2/BVI_Business_Companies_Act_2004_Revised_1_1_06.pdf.

investors can operate. This context also makes BVI a more acceptable jurisdiction of incorporation for companies with the purpose of entering foreign markets.

All these features have built throughout the years the status of tax haven of BVI.

3.2.1 Economic Activity

The economy of BVI, like other small Caribbean jurisdictions, such as the Cayman Islands, relies on tourism and financial services.

This jurisdiction offers a wide range of financial services to international investors, such as banking services, asset management companies, captive insurers, tax planning and registration of offshore corporations and trusts; in particular, BVI plays an important role as global financial services center precisely for its specialization in companies and trust incorporation. It is also the second largest global domicile for investment funds.

The financial services sector is regulated by an independent supervisory authority, the Financial Services Commission (FSC), which has broad powers in regulating, supervising and enforcing financial services activities carried on in the BVI, including insurance, banking, money services business, company management, mutual funds business, registration of companies and limited partnerships, and is also responsible for supervising the compliance of companies and partnerships with the corporate legislation (IMF 2010: 13).

The BVI also provides administrative, audit and legal services to IBCs, and these range of services are an important component of the domestic economy; apart from them, the local banking and the insurance sector is relatively limited.

According to estimates, in 2008 there were 7 banks in the territory of BVI, including three branches, three subsidiaries of foreign banks and one government-owned domestic bank; the banking system collectively managed $2.5 billion in assets, and the size of assets held by banks ranged between $98 million and $915 million.

The law in BVI does not directly prohibit the establishment of shell banks in the jurisdictions, but the strict requirements for the creation and licensing of banks prevent the operations of shell banks within the territory. The insurance sector is dominated by

captive insurers, estimated to be 287 by 2008, whose majority is composed by single-parent captives with parents located in the United States (IMF 2010).

Together with Cayman Islands, BVI manages a remarkable amount of assets. It is estimated that 55% of world hedge funds and 12% of global private equity funds are held in these two jurisdictions. According to estimates, by the end of 2006, the total amount of hedge fund assets held in the Caribbean tax havens, including BVI, Cayman Islands, Bahamas and Bermuda, reached $743.296 million, of which BVI alone accounted for $150.559 (Sullivan 2007b).

The number of entities established in the BVI is considerable, given the small size of the territory: by 2007 there were nearly 802,000 IBCs and 402 captive insurance companies; 9 banks were located there (Palan, Murphy, Chavagneux 2013: 58). By the end of 2008, the number of BVI Business Companies and IBCs located there was estimated at 414,620 (Caruana-Galizia, Caruana-Galizia 2016: 4).

Like other tax havens and offshore jurisdictions, BVI also made a commitment to cooperate with the OECD in its project of counteracting harmful preferential tax regimes, and also has implemented a comprehensive set of international cooperation legislation and procedures with the purpose of assisting tax and regulatory authorities; such regulatory framework provides an efficient mechanism for cross-border cooperation and exchange of information with international organization and tax authorities (IMF 2010: 51).

BVI also has signed international agreements providing for the exchange of information with regard to taxation purposes; in detail, it has signed 23 Tax Information Exchange Agreements with Aruba, Australia, China, Curaçao, Czech Republic, Denmark, Faroe Islands, Finland, France, Germany, Greenland, Guernsey, Iceland, India, Ireland, Netherlands, New Zealand, Norway, Portugal, Sint Maarten, Sweden, United Kingdom and United States; it has also signed a Double Taxation Convention with Switzerland.[115]

However, regardless its commitments to implement international standards with regard to taxation and information exchange, it has not yet substantially implemented them and it still continues its activity as a tax haven for investors all over the world.

115*British Virgin Islands: Guide to Doing Business,* http://www.lexmundi.com/lexmundi/Guides_To_Doing_Business.asp, accessed 14/03/2017.

3.2.2 Companies Business Act and Incorporation

Usually, offshore jurisdictions provide many different types of financial services, but each one is traditionally focused on one specific sector, for which it becomes well-known among investors all over the world: the Cayman Islands focuses on banking sector and fund management, whereas the BVI is considered the world's principal offshore incorporation jurisdiction (Wilson 2014).

In general terms, the BVI and the Cayman Islands offer similar services to international investors and to Chinese ones: in particular, they offer no or low tax rates, they ensure anonymity and secrecy to investors that want to conceal their identity from their home country authorities; they provide a tax neutral platform in order to structure investments, and they allow Chinese enterprises to gain access to international capital markets in order to raise funds and circumvent the imperfections of the domestic markets.

However, even if in broader terms they both serve the same function, they differ with regard to the specialization of the services they provide, being Cayman Islands focused on banking sector and funds while BVI focused on incorporation. In fact, BVI has the largest registry of international companies of the world and, consequently, plays a major role in the structure of global finance.

BVI provides a number of advantages with regard to the incorporation of companies, and such lightly regulated environment is appealing for non-residents that want to carry on business through an offshore vehicle.

First, as an English common law jurisdiction, its legal principles conform with principles of English common law, including issues related to limitation on shareholder liability, minority investor protection and directors' fiduciary duties;[116] hence, such legal context is familiar to international investors, which feel more confident in dealing with it. Another appealing feature of the legislation in BVI is the fact that no governmental approval is required for the incorporation of companies.

Moreover, the annual reporting requirements are minimal, and it is not required to file financial statements with authorities; also, audit is not required. Also with regard to

116http://www.walkersglobal.com/images/Publications/Memo/BVIMemos/BVI__Cayman__Listing_of_Cayman_and_BVI_Companies.pdf, accessed 16/03/2017.

trusts, it is required a fee of $100 for the creation, but there is no requirement to register a trust or any details of it, and there is no register of all trusts. Information regarding trusts is only maintained by licensed trust-service providers (IMF 2010: 49) and, this way, it is assured confidentiality.

Furthermore, it is not necessary to appoint BVI resident directors or officers in BVI incorporated companies, and the only prohibition imposed to them is the fact that companies incorporated by non-residents cannot carry on business with BVI residents. This is one of the provisions that identify regimes so called ring-fenced, that is, the regime applied to non-residents is partly or fully segregated from the one applied to residents. It includes also the prohibition for domestic residents to access to the preferential regime with regard to taxation offered to foreign investors. The prohibition for non-residents investors to carry on business with residents, in fact, suggests that the jurisdiction want to protect its domestic economy, by isolating the economic activities carried on by non-residents. Just like Cayman Islands, also BVI falls into the category identified by the OECD of ring-fencing of regimes, which is one of the criteria used to identify tax havens and harmful preferential tax regimes.

The registration of companies within the territory is governed by the BVI Business Companies Act, 2004, and its amendments. According to IMF estimations, by 2008 the companies incorporated in BVI managed nearly $615 billion in asset holdings, which makes BVI the largest global offshore center after Cayman Islands; however, although assets are domiciled within its territory, almost the totality of enterprises undertakes their business activities outside the territory, so that the capital do not actually flow into the BVI (IMF 2010: 12).

This is precisely one of the main features pointed out by the OECD for identifying a territory as a tax haven, that is, the absence of substantial business activities within the country: given the huge amount of entities incorporated in the BVI, it would be expected to have a consistent bulk of activities undertaken there. The association with a huge number of incorporations and no substantial activities suggests that the territory offers itself to non-residents as a location for incorporation of shell companies and for booking transactions, actually undertaken elsewhere, for several purposes, ranging from tax-minimation, secrecy or other purposes.

Companies incorporated in the BVI are commonly used as listing vehicle in order to access international capital markets, and also serve as holding companies in group structures. Offshore holding companies are commonly used to control the operating companies under their direct ownership, and are also used to realize the acquisition or the sale of such companies (Wilson 2014: 231); by structuring the deal offshore it is possible to overcome the constraints and certain kind of limitations imposed by Chinese law. In fact, the BVI is recognized as the main source of FDI through the registration of corporations that are capitalized to invest, or reinvest, into China; in particular, the main structure established within this jurisdiction is the International Business Company[117] (IBC).

IBCs are limited liabilities companies[118] established to serve as subsidiaries of parent companies located in other countries, or as independent companies, and their incorporation allows companies to effectively relocate their business or assets in the offshore jurisdiction. These entities can be used in order to own and run business there, to raise capital by issuing bonds and shares or in other ways. Also, they can be used for the legal possession of property rights, for managing investment funds and as a part of complex financial structures.

Another characterizing feature of IBCs, which makes them appealing for the use by international investors, is the secrecy of ownership: in fact, they are not subject to the disclosure requirements normally imposed on limited liabilities companies. Commonly, in offshore jurisdictions such as the BVI, there are no filing requirements and the information usually publicly released are kept secret. Furthermore, IBCs can be set up with only one director, or also a domestic resident may serve as nominee director, and by using this strategy the identity of the real directors is disguised (IMF 2002).

Under the provisions contained in section 98 (1b) of the BVI Business Companies Act 2004, a

> […] company shall retain the records and underlying documentation for a period of at least five years from the date of completion of the transaction to which the records and underlying documentation relate; or the company terminates the

117This structure has already been discussed in chapter 1.6.2.

118Legal arrangements such that the shareholders' liability is limited to the amount of capital they have invested (Simon 1998: 94).

business relationship to which the records and underlying documentation relate.[119]

The creation of IBCs also is also facilitated by the low costs of incorporation; fees to be paid are specified in section 236 of the BVI Business Companies Act 2004: for the incorporation of a company that is authorized to issue no more than 50,000 shares the incorporation fee is $350; for a company authorized to issue more than 50,000 shares is $1,100; for the incorporation of a restricted purpose vehicle is $5,000.

Companies incorporated in the BVI are also subject to a minimal annual fee, which is included in the same section of the Act, which indicates that the annual fee for a company authorized to issue no more than 50,000 shares is $350, for a company authorized to issue more than 50,000 shares is $1,100, and for a restricted purpose company is $5,000[120].

Hence, due to the ease of their creation and the limited regulatory obligations imposed on them by the offshore jurisdictions, there has been a proliferation of IBCs: only in 2010, BVI registered 59,624 new incorporations within its territory, and at that time the total amount of active companies was 459,364 (Vlcek 2013: 539), which is a huge proportion if compared to the small dimension of its territory.

3.2.3 FDI Flows

The preferential regime with regard to taxation and the fact that it offers itself as a favorable offshore location for routing capital, investment and booking transactions, has attracted huge amount of foreign capital within the small territory of BVI throughout the years. Also in the BVI, it is possible to notice the same evidence of tax haven status noticed with regard to the Cayman Islands: the financial activities undertaken in BVI far exceed the domestic financial needs, and this is due to the fact that the jurisdiction substantially offers financial services to non-residents.

According to the UNCTAD, in 2012 the BVI received FDI inflows for an amount of nearly $74 billion, becoming the fifth biggest FDI recipient in the world; also, the

119BVI Business Companies Act, 2004, http://www.bvifsc.vg/Portals/2/BVI_Business_Companies_Act_2004_Revised_1_1_06.pdf.

120BVI Business Companies Act, 2004, http://www.bvifsc.vg/Portals/2/BVI_Business_Companies_Act_2004_Revised_1_1_06.pdf.

FDI outflows from BVI reached $54 billion at that time: these amounts are clearly disproportioned if compared to the small size of the domestic economy of the country. As a term of comparison, in 2012 the United Kingdom received FDI inflows for $46 billion: looking at these figures the disproportion is still more evident, given that the economy of the United Kingdom is 3000 larger than the economy of the BVI.

On the whole, through offshore jurisdictions such as the BVI it is channeled an incredibly high amount of funds: in 2015, the investment flows routed in the Caribbean area reached $72 billion, and a great proportion was channeled through two tax havens only, the BVI and Cayman Islands, which between 2010 and 2014 received the 65% of the total investment originated from Hong Kong, China and the Russian Federation (UNCTAD 2016: 20).

This unbalanced pattern of FDI, hence, is the signal that this jurisdiction plays a relevant role in the global economy, that is, it is an offshore hub for international investments that come from other countries. Also, it is possible to notice an unbalance also in the comparison of inward and outward FDI flows and the domestic GDP, as the resulting percentage is really high given the small dimension of the domestic economy. The amount of FDI inflows and outflows, and the proportion compared to the domestic GDP and compared the global amount of FDI flows between 2000 and 2015 is shown in table 3.

Table 3. BVI Data

Year	Inward FDI Flow (in billion)	Percentage of total world	Percentage of domestic GDP	Outward FDI flow (in billion)	Percentage of total world	Percentage of domestic GDP
2000	$8.097	0.5%	1,078%	$37.145	3.1%	4,946%
2001	$3.790	0.5%	467%	$30.115	5.1%	3,717%
2002	$5.451	0.9%	693%	$14.130	2.8%	1,797%
2003	$9.661	1.7%	1,356%	$14.922	2.8%	2,095%
2004	$28.310	4.1%	3,794%	$10.946	1.2%	1,467%
2005	– $7.142	– 0.7%	– 820%	$18.253	2.2%	2,098%
2006	$12.015	0.8%	1,275%	$29.960	2.2%	3,177%
2007	$37.140	1.9%	3,673%	$50.484	2.3%	4,993%

2008	$52.583	3.5%	5,300%	$46.919	2.7%	4,729%
2009	$41.590	3.5%	4,747%	$37.259	3.3%	4,253%
2010	$51.226	3.6%	5,729%	$53.356	3.8%	5,968%
2011	$57.576	3.6%	6,285%	$59.934	3.8%	6,543%
2012	$74.502	4.9%	8,192%	$54.110	4.1%	5,950%
2013	$112.128	7.8%	12,246%	$103.290	7.8%	11,281%
2014	$49.986	3.9%	5,539%	$81.192	6.1%	8,997%
2015	$51.606	2.9%	5,549%	$76.169	5.1%	8,190%

(Source: UNCTAD Statistics, http://unctadstat.unctad.org)

3.2.4 Relationship with China

Due to the substantial role of the BVI in the global funds industry and in the global finance infrastructure, and due to the fact that it is commonly used by investors from all over the world to structure their investment, it can be easily understood the reason why BVI is also a significant player in the Chinese FDI (Wilson 2014: 215).

The BVI does not differ from the Cayman Islands in the fact that it has a high quality commercial law and its financial sector relies upon professionals, in addition to the advantages with regard to the low tax rate it provides and the lightly regulated environment: these are the key factors attracting non-resident investors, in particular Chinese ones.

It plays a leading role in Chinese FDI: offshore vehicles established in its jurisdiction are often used to structure investment into Chinese companies or investment in other countries, in order to minimize risks and overcome the imperfections of Chinese legal system (Wilson 2014: 210). With regard to China, the BVI also plays a major role in the process of round-tripping of funds, as Chinese capital is routed through a company incorporated there and then return to China disguised as foreign capital.

The BVI, together with Hong Kong, is one of the major sources of Chinese inward FDI and also, together with Hong Kong and the Cayman Islands, is one of the main hubs that receive investment from China and then redirect them towards China in the form of foreign FDI, through the process of round-tripping. BVI is hence recognized as one of the main centers of Chinese offshore activity (Haberly, Wójcik 2015: 25).

By 2009, BVI was the second major source of FDI into China, and from 2004 to 2010 it has been among the five principal destinations of Chinese outward FDI; the volume of capital flows from BVI to China increased remarkably throughout this period: from $6,730.30 million in 2004 and $9,021.67 million in 2005, reached $11,247.58 million in 2006 and peaked in 2007 with a total amount of $16,552.44 million. After that, even if the FDI flow is still consistent, it is registered a decrease throughout the years until 2015, when the FDI flow increased again.

Also, the amount of Chinese FDI towards the Caribbean destination had been considerable throughout the years: it peaked in 2011 with $6,208.33 million, and after that registered a constant decline until 2015, in which it was at the lowest level since 2009. The magnitude of FDI from BVI directed to China between 2006 and 2015, and Chinese FDI towards the same location, are shown in Table 4.

Table 4. BVI-China FDI Statistics

	Chinese Inward FDI from BVI (in million)	Chinese FDI to BVI (in million)
2006	$11,247.58	$538.11
2007	$16,552.44	$1,876.14
2008	$15,953.84	$2,104.33
2009	$11,298.58	$1,612.05
2010	$10,447.34	$6,119.76
2011	$9,724.95	$6,208.33
2012	$7,830.86	$2,239.28
2013	$6,158.58	$3,221.56
2014	$6,225.66	$4,570.43
2015	$7,387.78	$1,849.00

(Source: National Bureau of Statistics of China, http://www.stats.gov.cn/english/Statisticaldata/AnnualData/)

3.2.5 Joint Ventures

Among all the offshore jurisdictions, BVI is frequently preferred for the establishment of JVs: offshore companies established in the BVI are often used to structure JVs, or to serve as investment holding vehicles within a JV structure. This choice is primarily driven by the quality of its legal infrastructure and the professionalism and expertise with regard to shareholder disputes involving international JVs. JV deals account for a great proportion in Chinese outward investment, as they are a means of sharing legal and financial risks in overseas investment.

As an example, the JV, in the form of equity JV with local enterprises, is the favourite form of investment in Africa undertaken by Chinese companies. Since 2009, China investment towards Africa kept growing at a remarkable rate, and by 2011 Africa was the fourth major destination of Chinese outward investment: at that time, there were more than 2,000 Chinese companies carrying on business there, and the total amount of investment reached over $40 billion, including direct investment of $14.7 billion (Zhu 2011: 75).

As an example, Zhongda International Holdings Limited, using a BVI subsidiary, entered into a JV with South African companies in a construction project of an electronic infrastructure in South Africa; also, Hoifu International Trading entered into a JV with Profit High International Enterprise Limited, and in this deal a BVI company was used as the JV vehicle for developing business in Africa (Wilson 2014: 232).

Investment in foreign jurisdictions clearly involve risks, in the form of management, cultural and legal risks, and disputes may arise; the use of offshore companies to structure JVs and overseas investment is also a means of containing such risks. Structuring the JV in the BVI or in other offshore jurisdictions is a means of protecting the investors from the risk of expropriation, protracted litigation, unforeseen costs and political interference, as it allows disputes to be settled in the offshore jurisdiction, which usually offers political stability, predictability and legal efficiency (Wilson 2014: 234).

Another reason underlying the use of BVI companies as JV vehicle, in fact, is due

to the unique statutory provisions in BVI law with regard to the protection of investors; section 120 (4) of the BVI Business Companies Act of 2004 states that:

> A director of a company that is carrying out a joint venture between the shareholders may, when exercising powers or performing duties as a director in connection with the carrying out of the joint venture, if expressly permitted to do so by the memorandum or articles of the company, act in a manner which he believes is in the best interests of a shareholder or shareholders, even though it may not be in the best interest of the company.[121]

The stable and predictable legal environment in BVI, hence, is suitable for structuring overseas investment and in particular JV deals, as it contains detailed provisions protecting the interests and rights of investors and regulating the settling of disputes, and for this reason it is preferred over other offshore jurisdictions.

3.2.6 The Case of China Able Ltd.

An example of the use of BVI companies in order to structure JVs is given by a company named China Able Ltd., which is a JV formed by various Hong Kong and mainland Chinese companies, some of them established in the BVI.

Celestial Asia Securities Holdings Limited (CASH Group) is a Hong Kong based financial services firm, incorporated in Bermuda, listed on the HKEX; it owns several subsidiaries, among which there are CASH Financial Services Group (CFSG), Pricerite Group, CASH Algo Finance Group (CAFG), CASH Retail Management Group (CRMG) and Net2Gather (China) Holdings.[122] Other controlled companies are Moli Group, a service provider whose headquarters are located in Shanghai, and Lifeztore (Shanghai) Ltd.

On 23rd May 2007 three companies, Marvel Champ Investment Ltd., Nanyang Industrial (China) Ltd. and Fit Team Holdings Ltd., formed a JV in equal shares, through the joint venture entity China Able Ltd (Maurer, Martin 2012: 537).

With regard to these three companies, Marvel Champ is a company incorporated

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121BVI Business Companies Act, 2004, http://www.bvifsc.vg/Portals/2/BVI_Business_Companies_Act_2004_Revised_1_1_06.pdf.

122http://www.cash.com.hk/en/aboutus.asp, accessed 14/03/2017.

in the BVI, which is owned for 65% by CASH Financial Services Group Ltd., which is a non-wholly owned subsidiary of CASH operating in China, and for 35% by an independent third party, Nanyang Holdings Ltd.; Nanyang Industrial (China) Ltd. was created in Hong Kong, and is a wholly owned subsidiary of a Bermuda securities investment company, Nanyang Holdings Ltd.; Fit Team Holdings Limited was incorporated in the BVI, and is owned for 50% by a company incorporated in Bermuda, Van Shung Chong Holdings Ltd., and for the remaining 50% by an independent third party.

After its creation, China Able Ltd. acquired Changyu, a company incorporated in China in 2006, which became an indirect wholly owned subsidiary of the JV. In fact, in 2007, Chengyu entered into a Memorandum of Understanding for the purchase of a property[123] at the price of RMB 420 million: China Able does not have any other material asset or investment rather than Chengyu, and the aim underlying its creation was merely to own, hold and manage the property through the indirect wholly-owned subsidiary.[124]

3.3 Hong Kong

3.3.1 International Financial Center

Hong Kong is not a tax haven, as the Cayman Islands and BVI are, or a so-called OFC, but it is commonly identified as an international financial center. Even if Hong Kong does not have a tax haven status, it has a tight relationship with mainland China with regard to investment flows; the motivations underlying the flows of investment between Hong Kong and China may be similar to those underlying Chinese investment in the Caribbean, yet there are some peculiarities.

Hong Kong was a small but extremely open economy, and it started to emerge as a financial center for the Asia-Pacific region in the 1970s; since then numerous

123The property to be acquired comprises a 11-storey office tower located in Shanghai, and covers a total gross floor area of approximatively 26,924 square metres.

124http://www.hkexnews.hk/listedco/listconews/SEHK/2007/0627/LTN20070627433.pdf, accessed 14/03/2017.

international financial institutions have been proliferating there, and the international orientation of banking and financial activities is traditionally considered the essential factor that turns a location into a financial center. In fact, the proliferation of non-domestic financial institutions suggests the undertaking of business non-only in the host country but also the channeling of funds and investment through the host country in order to be redirected elsewhere. Hence, Hong Kong started to develop and to provide sophisticated services, not only banking operations but also other complementary or ancillary financial services.

The attractivity for international financial intermediaries was also due to other factors, both locational and legislative: first, the central position of Hong Kong, supported by an excellent system of infrastructure and telecommunication facilities, has always been an advantage for the territory, its proximity to many countries in the Asia-Pacific area and in particular to mainland China also facilitated the contact with Chinese market for financial but also non-financial firms.

Hong Kong has a free exchange market, has a stable currency and, even if it's not a no-tax jurisdiction, it has a simple taxation system with low rates. The income and profit tax rate is fixed at 15%, and only the income derivated from operations undertaken within the territory is subject to taxation, so that any foreign-sourced income remitted to Hong Kong is not taxed under Hong Kong law; both factors are equally attractive for non-residents intermediaries. Moreover, there is no sales tax, no withholding tax on dividends and interest, no capital gains tax, no value-added tax and no estate duty.

Furthermore, an essential factor determining the success of Hong Kong as financial center is the free convertibility of currency; in fact, a location is attractive for foreign investors only if their funds can be easily repatriated or transferred elsewhere. Hong Kong is one of the most free and open economies in the world, and by contrast to mainland China, capital can be freely moved in and out of the jurisdiction.

Other motivations underlying the attractivity of Hong Kong are due to its former status of English Colony: the English as official language in Hong Kong, which is the global language of commerce and finance, and the legal system of the jurisdiction, which is based on English common law (Jao 1979).

Hence, in general terms, Hong Kong has an efficient and strong legal and judicial framework, which provides a stable regulatory and business environment; it also has foreign-skilled professional available, and offers a high degree of banking confidentiality; all these factors contribute to attract foreign capital and foreign financial intermediaries in the territory, and consequently help building the status of international financial center.

The status of financial center of Hong Kong is the pillar on which its economic prosperity relies on, and on which has to be built its entire economy. For this reason, article 109 of the Hong Kong Basic Law[125] stipulates that:

> The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial center.

Whereas article 110 explicitly states that the Government

> […] shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with the law.[126]

Hong Kong provides a stable and transparent regulatory regime to investors, which has international acceptance, because it is in line with international standards and practices; also financial sectors such as banking, insurance and securities are in line with practices to which international investors are familiar to and in which they feel confident to operate in. In 2011 Hong Kong was ranked first among the 60 leading financial systems and capital markets in the world.

125The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, which was adopted on 4 April 1990 at the 3rd Session of the 7th National People's Congress and entered into effect on 1st July 1997.

126The Basic Law of the People's Republic of China, http://www.cmab.gov.hk/doc/en/documents/policy_responsibilities/Racial_Discrimination/AnnexI-Eng.pdf, accessed 20/03/2017.

3.3.2 FDI Flows

Hong Kong is the main source of investment into China in the form of FDI; its direct investment into China are considered as FDI because, although Hong Kong returned to China in 1997, it has the status of Special Administration Region (SAR) under the principle of "one country and two systems";[127] hence, given that Hong Kong has a political and economic system separated from the Chinese one, its direct investments are treated as FDI and not as Chinese internal capital flow.

Besides being the major source of investment into China, Hong Kong is a major hub for investment from and to all over the world, and, as shown in table 5, through its jurisdiction is channeled a great proportion of global FDI.

Table 1. Hong Kong Data

Year	Inward FDI Flow (in billion)	Percentage of total world	Percentage of domestic GDP	Outward FDI flow (in billion)	Percentage of total world	Percentage of domestic GDP
2000	$54.582	4.0%	31.79%	$54.079	4.6%	31.5%
2001	$29.061	4.2%	17.15%	$18.055	3.1%	10.66%
2002	$3.661	0.6%	2.2%	$13.162	2.6%	7.91%
2003	$17.831	3.2%	11.1%	$12.057	2.3%	7.47%
2004	$29.154	4.2%	17.2%	$43.637	4.8%	25.81%
2005	$34.058	3.6%	18.8%	$27.003	3.3%	14.87%
2006	$41.811	2.9%	21.6%	$44.475	3.3%	22.98%
2007	$58.404	3.1%	27.6%	$64.166	2.9%	30.32%
2008	$58.315	3.8%	26.6%	$48.379	2.8%	22.06%
2009	$56.061	4.7%	26.1%	$59.728	5.4%	27.90%
2010	$72.319	5.2%	31.6%	$88.025	6.3%	38.50%
2011	$96.212	6.1%	38.7%	$95.972	6.2%	38.62%
2012	$70.841	4.6%	26.9%	$84.072	6.4%	32.01%

127"One country, two systems" is a constitutional principle formulated by Deng Xiaoping in the 1980s for the reunification of China; under this principle, there is only one China but distinct Chinese regions, such as Hong Kong and Macau. After the return to China in 1997, Hong Kong mantained its capitalistic economic system, its own political, legal and legislative system and its own currency; the agreement with China stated that it will mantain its status as special administrative region, and its own separate systems, for fifty years.

2013	$74.546	5.2%	27.0%	$81.025	6.2%	29.38%
2014	$114.055	8.9%	39.2%	$125.109	9.5%	43.01%
2015	$174.892	9.9%	56.9%	$55.143	3.7%	17.96%

(Source: UNCTAD Statistics, http://unctadstat.unctad.org).

3.3.3 Relationship with China

With regard to China, Hong Kong serves a double function: on one hand, it gives international investors access to the opportunities in the Chinese market, while on the other hand it connects China to the international financial markets.

Hong Kong has become the preferred listing place for international corporations, and has also been the initial bridge between China and the global markets; this role, in particular, was due to its financial skills and expertise needed by Chinese economy. The financial services in Hong Kong, including banking and insurance sectors, investment and holding companies, have always been more mature and developed than the ones in mainland China, and Hong Kong had the characteristics for being an international financial center.

After the announcement in the 1980s that Hong Kong would return to China in 1997, many companies based there decided to relocate their domicile to offshore jurisdictions, such as those in the Caribbean; this measure was intended to prevent the risk of expropriation by the Chinese government, and as an overall defensive measure.

The preference for Caribbean jurisdictions was driven by the similarities in the legal systems, because both Hong Kong and Caribbean tax havens, such as the Cayman Islands and BVI, have a system based on English common law. In fact, in 1993 it was estimated that nearly 60% of Hong Kong based companies moved their domicile in the Caribbean jurisdictions.

Moreover, the HKEX also introduced some provisions allowing firms incorporated in certain jurisdictions to list on the exchange; in this way, it was possible to maintain the business of Hong Kong-based firms listed in Hong Kong which decided to shift their domicile offshore before 1997.

In particular, in Chapter 11 paragraph 5 of the Listing Rules issued by the stock

exchange it is specifically stipulated that:

> The issuer must be duly incorporated or otherwise established under the laws of Hong Kong, the PRC, Bermuda or the Cayman Islands and must be in conformity with those laws.[128]

3.3.4 Triangulation: Hong Kong, Caribbean, China

The relationship between Hong Kong and the tax havens Cayman Islands and BVI remained constant throughout the years, and it is possible to notice a triangulation of investment between Hong Kong, the Caribbean area and China.

The motivations underlying the capital flows are various, in fact Hong Kong is important for several aspects with regard to Chinese capital inflow and outflow: it may be the listing place for a listing vehicle incorporated offshore, or it may be the hub through which Chinese investment is channeled before being redirected back into China or elsewhere.

Hong Kong provides two advantages: on one hand, it offers physical proximity to mainland China, which make it more convenient for Chinese investors that want to operate in China to use Hong Kong for certain business operations, because the investment is closer to the market in which it is intended to be used; on the other hand, it shares the regime of common law with the Caribbean havens of Cayman Islands and BVI, that are the most commonly used by Chinese investors, and the sharing of the basic principles of common law facilitates the interaction between these locations.

As reported by official statistics, from 2004 and 2010, China has been the major source of FDI into Hong Kong, followed by BVI; Cayman Islands was present among the top five sources of investment.

In particular, investment coming from China peaked in 2008, and remarkably increased again in 2010; with regard to BVI, the amount of FDI decreased in 2005 and then slowly continued to grow until reached a peak in 2010. By contrast, FDI from Cayman Islands fell in 2008 and 2009, and then increased again since 2010.

In Table 5 is reported the amount of FDI between 2010 and 2015; it is possible to

128Disclaimer for the Consolidated GEM Listing Rules, http://en-rules.hkex.com.hk/net_file_store/new_rulebooks/c/o/consol_gem.pdf, accessed 2/03/2017.

notice that BVI and China are still the two major sources of inward FDI in Hong Kong, and Cayman Islands maintains the position among the top five sources. Again, it is possible to notice a fluctuation in the flows, in particular in 2013: BVI investment registered a considerable increase, and so did Cayman Islands', while Chinese FDI collapsed. Also, Cayman Islands FDI had a boost in 2015.

Table 5. Flow of Inward FDI to Hong Kong (HK$ billion)

Jurisdiction	2010	2011	2012	2013	2014	2015
BVI	253.4	151.5	191.9	341.9	476.7	437.5
China	276.3	318.1	232.7	46.6	221.8	200.8
Cayman Is.	19.8	20.0	12.6	34.4	16.7	404.3
Netherlands	36.7	59.6	37.8	16.1	44.8	34.4
Bermuda	24.2	40.3	73.0	45.7	- 4.7	59.4
Singapore	15.5	82.6	17.1	14.0	59.0	23.3
USA	- 154.4	21.9	- 120.8	21.2	8.3	3.0
UK	12.3	1.6	43.9	23.1	44.4	55.9
Japan	17.3	5.0	7.7	6.3	10.8	22.5
Cook Is.	4.2	6.3	10.1	15.6	9.8	6.3
Others	46.9	45.0	38.3	11.4	- 10.9	104.2
Total	406.1	751.8	544.3	576.2	876.5	1,351.5

(Source: Census and Statistics Department, https://www.censtatd.gov.hk).

With regard to Hong Kong FDI it is possible to notice that the major destinations of investment are still China and BVI, and also Cayman Islands is an important recipient. Between 2004 and 2010 the most relevant fluctuation in the pattern of investment flows was registered in 2007, when FDI towards China, BVI and Cayman Islands had a boost; in the following three years, the amount registered a decrease, in particular with regard to Cayman Islands, whereas although the decrease it remained consistent with regard to China and BVI.

As shown in Table 6, FDI towards Cayman Islands remarkably increased in 2011 and then again in 2014 and 2015; also investment towards China duplicated in 2014, coming back to the level of 2013 in the following year. By contrast, FDI towards BVI

followed the opposite path and almost halved in 2013 and 2014, becoming negative in 2015.

Table 6. Flow of outward FDI from Hong Kong (HK$ billion)

Jurisdiction	2010	2011	2012	2013	2014	2015
BVI	239.0	254.4	275.4	155.9	150.9	- 16.4
China	329.7	393.1	296.6	396.9	637.9	306.6
Cayman Is.	1.0	46.8	- 16.1	19.5	64.9	224.5
UK	- 1.3	13.1	12.6	1.7	2.2	17.1
Bermuda	19.3	29.2	28.1	22.4	26.2	24.0
Australia	/	8.8	12.2	9.2	15.6	0.6
USA	/	- 13.7	- 5.9	5.6	3.6	- 17.0
Canada	/	- 0.5	- 2.4	- 0.9	/	0.2
Singapore	12.7	4.0	10.5	- 2.2	11.3	- 8.2
Luxembourg	/	4.9	0.7	0.2	- 1.7	- 0.4
Others	50.3	18.9	35.3	18.2	51.4	25.6
Total	741.1	749.9	647.0	626.5	962.2	556.7

(Source: Census and Statistics Department, https://www.censtatd.gov.hk).

3.3.5 Listing

For Chinese firms, in particular in the private sector, it is difficult to gain access to capital in the Chinese capital market; thus, it is vital for them to gain access to capital through the listing in international markets.

As mentioned before, in order to list on US stock exchange, many Chinese firms incorporate a listing vehicle in the Cayman Islands and then hold an IPO on international markets for fund raising. Also Hong Kong stock exchange serves the same function: many Chinese firms decide to list there, for both providing opportunities for international investors and raising funds in order to finance activities back in mainland China. Another advantage provided by the listing on the HKEX is the attractivity for international investors, which are familiar with the regulatory standards implemented in Hong Kong.

In particular, after the implementation in 2002 of the Sarbanes-Oxley Act,[129] which imposed stricter requirements for companies listed on US stock exchanges, Hong Kong became one of the major exchanges where Chinese firms held IPOs. On one hand, the shift of preference towards listings on HKEX rather than US stock exchanges is due to the higher cost of complying with such requirements; another obstacle is the economic size required for the IPOs on the NASDAQ.

Another factor which increased the attractivity of the HKEX is its improved liquidity, and the proximity to the mainland market in which many Chinese listed firms conduct their primary businesses (Greguras, Bassett, Zhang 2008: 1).

In terms of value, from 2003 to 2011, Chinese firms listed on the HKEX raised a total amount of $318 billion. In 2016 there were 1,924 companies listed on the HKEX, of which 980 were Chinese firms, corresponding to 51%. At that time, Chinese enterprises accounted for 62.6% of the market capitalization and for 69.9% of the equity turnover of listings.[130]

Chinese companies can list on the HKEX directly, through an "H share listing" or indirectly, through a "red chip" listing. The first type of listing refers to companies incorporated in China which have received the permission by authorities to list on the HKEX; whereas the term red chip refers to the listing of shell companies that are incorporated outside China, mainly in Hong Kong, Cayman Islands, British Virgin Islands or Bermuda, which are controlled by Chinese nationals, both entities or individuals, and are listed on overseas stock exchanges, in particular on HKEX.

In detail, in the process of red chip listing, the Chinese firm establishes a holding company in the offshore jurisdiction in the form of a SPV, which then acquires the Chinese firm operating in the mainland, that becomes its wholly owned subsidiary.

However, after the implementation in 2006 of the Provisions on Acquisitions of

129The Serbanes-Oxley Act was enacted on 30 July 2002 and was aimed at protecting investors by improving the accuracy and reliability of corporate disclosures. It introduces major changes to the regulation of financial practice and corporate governance, and it enhance financial disclosure. It applies to all publically held American companies, any international company that have registered equity or debt securities with the US Security and Exchange Commission (SEC), and any accounting firm or other third party that provides financial services to the previously mentioned companies, and its application is mandatory (source: https://www.sec.gov/about/laws/soa2002.pdf, accessed 13/03/2017).

130https://www.charltonslaw.com/legal/ipo/Listing-PRC-companies-on-the-HKEx.pdf, accessed 26/03/2017.

Domestic Enterprises by Foreign Investors, referred to as M&A Rules, by the MOFCOM, the requirements introduced virtually prevented any approval to the process of restructuring Chinese firms into offshore holding companies. In fact, under the Rules, the central government approval is required before the establishment of a SPV in an offshore jurisdiction for the purpose of listing in an international stock market, in the case the offshore entity is under direct or indirect control of a Chinese national; moreover, government approval is required also before the offshore SPV effectively acquires the Chinese firm in the mainland.

However, although M&A Rules addressed the issue of offshore restructuring and international listings with the purpose of preventing such process, still a great number of Chinese companies carried on the offshore restructuring and effectively listed through the offshore vehicle, by using different reorganization strategies. In particular, the most commonly used structure to achieve this purpose is the VIE.[131]

As an example of a company that managed to restructure itself offshore after the issuing of M&A Rules in 2006 is China Zhongsheng Resources Holdings Limited: in the origin, it was a Chinese firm, and undertook the restructuring in order to list on the HKEX as a red chip company. It transformed into a Sino-foreign enterprise and then, after an acquisition, became a wholly foreign-owned enterprise; after that, it listed on the HKEX. This listing, which was achieved through various stages of restructuring, received the government approval and it can be seen as a successful example of circumventing Chinese regulations.[132]

3.3.6 Closer Economic Partnership Arrangement (CEPA) and Double Tax Agreement

The relationship with China with regard to trade and investment has been further strengthened by the implementation of the Closer Economic Partnership Arrangement (CEPA); the main text of the arrangement was signed on 29 June 2003, and became

131The entities involved in the VIE structure and its uses has been discussed in the previous chapter in paragraph 2.5.

132https://www.charltonslaw.com/legal/ipo/Listing-PRC-companies-on-the-HKEx.pdf, accessed 26/03/2017.

effective in 2004.

CEPA has the purpose of improving the joint development of Hong Kong and China: it is the first free trade agreement between the two parties, and it covers three broad areas: trade in goods, trade in services, trade and investment facilitation. The purpose of CEPA is to promote the economic integration and to accelerate the economic and trade development of the two sides; in fact, it tightens the already close economic cooperation between Hong Kong and China.

In particular, CEPA addressed the issue of trade barriers, liberalization of trade in services and the promotion of trade and investment: its purpose was to progressively reduce, or eliminate, tariffs and non-tariff barriers on the trade of goods between Hong Kong and China, and also to achieve the liberalization of trade in services, by reducing or eliminating discriminatory measures. Moreover, under articles 23 and 16, CEPA had the purpose of strengthening the cooperation in financial sectors, such as banking, securities and insurance and of facilitating the trade and investment between the two sides, by providing greater transparency, by applying international standards and enhancing the exchange of information.[133]

Between 2004 and 2013 Hong Kong and China signed ten Supplements, in order to expand the contents of the CEPA, in line with article 3, which provides that the two parties will enrich the content of the arrangement by implementing continuous liberalization between them. Other amendments have also been made, and in particular in November 2015 it was signed the Agreement on Trade in Services, which expanded the liberalization of trade in services between Hong Kong and mainland China, and further opened up the services market.

CEPA is a win-win agreement, as it creates new opportunities for business for Hong Kong, Chinese and foreign investors; it provides improved access to Hong Kong-based firms to Chinese markets and also permits Chinese business to gain access to global markets: this is precisely the role that Hong Kong has always played with regard to China, and the implementation of this agreement is a way to enhance an already close relationship.

Furthermore, in August 2006 Hong Kong and China signed a bilateral tax treaty,

133CEPA, https://www.tid.gov.hk/english/cepa/, accessed 26/03/2017.

the Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion, with the purpose of avoiding the double taxation of income: the purpose of Double Tax Treaties is to prevent the taxation of the profit of companies that operate on a cross-border level both in the place of legal incorporation and in the place in which the income arises. Ideally, such treaties are intended to avoid the double taxation but, in practice, they are exploited as loopholes in the legislation with the purpose of minimizing the tax burden.

With regard to China, before the implementation of the EIT Law in 2008, dividends paid by FIEs to foreign investors were exempted from the payment of withholding taxes, whereas, after 2008, new provisions were introduced, including a withholding tax of 10%. However, the same law also stipulated that, in the case of existence of a tax treaty between two countries, the withholding tax should be reduced at 5%: this is precisely the case of Hong Kong. Article 10 (2) of the Double Tax Treaty states that:

> [...] if the beneficial owner of the dividends is a resident of the Other Side, the tax so charged shall not exceed: where the beneficial owner is a company directly owning at least 25% of the capital of the company which pays the dividends, 5% of the gross amount of the dividends.[134]

Whereas, in case of companies owning less than 25% of the capital, the tax rate applied is 10%.

The consequence of such provision is that, after the implementation of the EIT Law, many Chinese firms moved their domicile to Hong Kong in order to enjoy the reduction on the dividends to be paid to the Hong Kong-based parent company.

On the whole, the tight relationship and the various measures implemented by the two sides were intended to reinforce and improve the commercial and economic cooperation, but they are also exploited by Chinese investors with the purpose of circumventing some restrictive Chinese requirements and to obtain various type of advantages and reductions with regard to taxes to be paid under Chinese law.

134Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion (2006), https://www.elegislation.gov.hk/hk/cap112AY!en@2006-10-27T00:00:00, accessed 29/03/2017.

3.3.7 Round-tripping

The proximity of Hong Kong to mainland China has always made it the preferred hub for channeling Chinese funds and investment that were going to be redirected back into China, and also made it the preferred hub through which foreign investors gain access to Chinese market.

In particular before 1997, Hong Kong had been the preferred location for the incorporation of IBCs by Taiwanese investors, with the purpose of undertaking investment in mainland China. The decision of channeling FDI via Hong Kong-based IBCs served the purpose of disguising the Taiwanese origin of the investment. However, after the return of Hong Kong to China, many Taiwanese investors moved their corporate domicile to offshore jurisdictions.

The strategy of channeling investment into China through Hong Kong companies was exploited not only by Taiwanese investors with the purpose of concealing the real ownership of the investment, but also by Chinese investors and foreign ones. The motivations underlying the use of a Hong Kong-based firm in order to invest into China are different: this strategy is driven by the purpose of round-tripping of Chinese investment and, especially before the new EIT Law was implemented in 2008, it was driven by the desire of benefiting from the preferential treatment accorded to foreign investors.

Hong Kong plays a relevant role in the three different stages of capital round-tripping: it is involved in the creation of new capital in China, it takes part in the flight of capital outside China and it is also involved in the process of round-tripping of such capital back into China (Xiao 2004: 2).

The motivations underlying the process of round-tripping are various: this process may be driven by tax advantages and incentives accorded to foreign investors, but may also be due to the pursue of better protection of property rights. Basically, the Chinese system for the protection and the enforcement of property rights is weak, and is very different from the legal systems in Hong Kong and in other developed economies: given the instability of Chinese legal system, investors find safer to have their investment channeled through Hong Kong, which provides to investors a stable and transparent

regulatory regime, which is in line with international accepted standards and practices.

Hong Kong, in fact, has always been a channel through which a high proportion of round-tripping investment directed into China are routed. It is considered that a percentage ranging between 10% and 66% of the FDI flows in China is composed by round-trip capital; whereas other estimates assesses the percentage between 40% and 60%. By 2008, according to the Chinese government, it was estimated that nearly two-thirds of Chinese FDI could be round-trip capital (Vlcek 2010: 121).

With regard to FDI flows between Hong Kong and mainland China, the amount of FDI from Hong Kong into China and Chinese FDI directed to it are shown in Table 7.

Table 7. Hong Kong-China FDI Statistics

	Chinese Inward FDI from Hong Kong (in million)	Chinese FDI to Hong Kong (in million)
2006	$20,232,92	$6,930,96
2007	$27,703,42	$13,732,35
2008	$41,036,40	$38,640,30
2009	$46,075,47	$35,600,57
2010	$60,566,77	$38,505,21
2011	$70,500,16	$35,654,84
2012	$65,561,19	$51,238,44
2013	$73,396,67	$62,823,78
2014	$81,268,20	$70,867,30
2015	$86,386,72	$89,789,78

(Source: National Bureau of Statistics of China, http://www.stats.gov.cn/english/Statisticaldata/AnnualData/).

A high proportion of FDI into China, however, is channeled through tax havens and Hong Kong not only with the purpose of round-tripping of Chinese capital, but is composed by capital originated in the United States or Japan which is invested in offshore jurisdiction with the purpose of avoiding taxes in the home country; that is, it is capital that benefits from the basic taxation advantage provided by tax havens, and is then used for undertaking several business transactions, included FDI in other countries

all over the world (Vlcek 2010).

3.4 Conclusions

This chapter took into consideration the three main jurisdictions that are the most important with regard to Chinese investment: it is possible to identify common characteristics in all of them, but yet their operate has some peculiar differences which are due to their location, their economic and legal system and their history.

The pattern of investment between these three jurisdictions and China has been constant throughout the years, however it possible to notice some fluctuation in the investments, registering a considerable growth in some years or, by contrast, a sudden reduction. These fluctuations may be due to changes in the political or economic situation of the country on the whole, maybe consequent to the implementation of new laws or regulations, but may also be driven by the decisions of the singular individuals, both in the case of corporations or persons, which decide to adopt a strategy involving an offshore investment by considering the benefits in their tax planning or their need of concealing their wealth from tax authorities.

This chapter investigated the main characteristics of Cayman Islands, BVI and Hong Kong which are considered to be attractive for foreign investment within their jurisdictions, but, obviously, the motivations underlying such movements may be extremely various.

Chapter 4
Conclusions

The existence of tax havens can be traced back in the early years of the twentieth century, however, their nature and the services they provide changed and evolved throughout the century until nowadays.

Starting from simply providing banking services to non-residents, tax havens improved their offerings and built a highly developed financial environment within their territory. Throughout the years there has been a proliferation of jurisdictions starting to offer themselves as tax havens and OFCs, and the underlying motivations can be identified in the changes occurring in the global economy and financial markets: haven jurisdictions exploit the circumstances that a globalized economy and the nature of financial wealth provide.

The capital flows channeled through tax havens fluctuated in the years, and it can be considered as a specular adjustment responding to changes, both economic and political, occurring inside countries all over the world. When the political situation inside a country appears to be more instable, or when new laws regarding taxation and property are established or are going to be established soon, as a response the amount of wealth shifted offshore increased, and increased the amount of capital channeled through offshore hubs.

The structures and the strategies adopted in tax havens in order to achieve a various range of purposes, from the mere tax avoidance to the purpose of fund raising or accessing to capital market, to the structuring of investment or transactions, to the circumventing of domestic restrictions, also changed and became more and more complex and sophisticated. Structures such as the IBCs, shell companies, insurance companies, trusts and other legal arrangements are the most widely used in offshore jurisdictions, but recently there has been developed more complex structures composed not only by a legal entity established offshore, or a chain of ownership between several entities, but composed by a complex matrix of contractual agreements that link together different types of entities: the VIE.

As we have seen with regard to China, the VIE is one of the most commonly used

structure to operate offshore, and its main purpose is to circumvent the restrictions that Chinese government imposes on foreign investment in certain sectors.

The structure of the VIE is precarious, and its legal validity under Chinese law is on the razor's edge; no precise legislation addressing the VIE currently exists, and in the future the legal validity of the existing VIEs will depend on the legislations that will be implemented.

Starting from the investigation of the characteristics and activities undertaken in tax havens, this thesis has been focused in its second part on the peculiarities of Chinese connection with haven jurisdictions. Just like the VIE structures is not yet addressed by any legislation specifically focused on the regulation of its use, on the whole, the issue of tax havens and the use Chinese nationals make of them is not openly discussed, in particular when it comes to members of the Chinese Communist Party or members of the top communist élite.

The establishment of offshore entities incorporated in tax havens is not in itself illegal under Chinese law, it may become an illegal practice when its purpose is circumventing the restrictions imposed by Chinese law in order to achieve objectives that otherwise wouldn't be allowed.

Not only private investors got involved in the process of investment offshore, but also many members of Chinese political élite: in 2014, the International Consortium of Investigative Journalists (ICIJ) published a document named "Offshore Leaks", which revealed the real owners of companies and accounts held in offshore jurisdictions. This document revealed that also individuals of Chinese élite were using offshore tax havens to hide assets, list companies on international stock exchanges and undertake businesses avoiding domestic government's control; in this document, at least 15 of China's wealthiest individuals, high-level executives and relatives of some former or current leaders were named.[135]

Hereafter, in May 2016, the International Consortium of Investigative Journalists released another document, the so-called Panama Papers, which included thousands of names of individuals and firms which hid wealth in tax havens. The data were sent to

135GUEVARA, Marina W. (January 21, 2014), *How We Did Offshore Leaks China*, in "The International Consortium of Investigative Journalists", https://www.icij.org/blog/2014/01/how-we-did-offshore-leaks-china, accessed 25/04/2017.

the German daily newspaper *Süddeutsche Zeitung* (SZ) by an anonymous source, and the SZ decided to analyze them in cooperation with the International Consortium of Investigative Journalists.

In this list, also nine exponents of the Chinese political élite were included: they are the ultimate owners of offshore companies established in tax havens, or use such jurisdictions to conceal their wealth. The information comes from documents owned by Mossack Fonseca, a Panama-based law firm which is specialized in selling anonymous offshore companies around the world and in creating tax shelters for wealthy clients.[136] There has been a leak of 11.5 million tax documents, covering the years from 1977 until 2015, involving 214,000 offshore entities; such information is linked to 140 political figures coming from more than 50 countries all over the world, including China.

The exponents of the Chinese political élite named in the leaked documents are former or current members of the Politburo Standing Committee, the most powerful body of the Communist Party, and also Xi Jinping's brother-in-law, Deng Jiagui, has been named.[137]

How did the Chinese government react to this leak of compromising information involving exponents of the political élite or relatives of the Communist Party's members? It censored the information.

After the disclosure by Panama Papers, information about this worldwide scandal appeared on the leading online newspapers, such as *The Guardian*: after the disclosure, its website had been blocked, and its articles had been inaccessible in mainland China. In 2014, after similar information leaked, the same happened, and the websites of newspapers reporting the news were blocked.

Also, the websites of *The Economist*, *Time Magazine*, and the International Consortium of Investigative Journalists, which had published the Panama Papers, were censored and were no more accessible in China. Chinese government blocked the access to sensible information, including both the publication of Panama Papers and every kind of articles mentioning Xi Jinping's relative involvement in the scandal or other kind of

136FORSYTHE, Michael (2016), *Panama Papers Tie More of China's Elite to Secret Accounts*, https://www.nytimes.com/2016/04/07/world/asia/china-panama-papers.html, accessed 26/04/2017.

137CHARLTON, Corey (2016), *Chinese President Xi Jinping's Family Used Offshore Tax Havens to Conceal Their Fortunes According to Panama Papers Leak*, http://www.dailymail.co.uk/news/article-3522433/Panama-Papers-family-Chinas-President-Xi-implicated.html, accessed 26/04/2017.

information involving political exponents linked to the Communist Party.[138]

When it comes to tax havens, China's reaction is not well-defined. On one hand, Chinese government, for example with the issue of Draft Law which takes into consideration the VIE structure and set out clear rules and limitations regarding its use, seems to be taking into consideration the widespread establishment of offshore companies by Chinese national for circumventing domestic restrictions, and seems to be determined to clearly address the problem for the purpose of eradicating it completely; on the other hand, when it comes to political exponents or major scandals that put China in a bad light, the solution is only one: to cover everything up.

When it comes to China, with regard to many controversial issues, it is difficult to see the truth and to gain reliable information in order to analyze the problem; Chinese government has always been adopting an astute censorship in order to manipulate and distort the information. With regard to tax havens, it seems to be alike: Chinese government is undoubtedly aware of the phenomenon and its extent, however, it is difficult to understand which is its official standpoint and when and how an effective counteraction will take effect.

138PHILLIPS, Tom (2016), *China Steps Up Panama Papers Censorship after Leader's Relatives Named*, https://www.theguardian.com/world/2016/apr/07/china-ramps-up-panama-papers-censorship-after-leaders-relatives-named, accessed 26/04/2017.

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