AVOIDANCE AND EVASION OF TAXES IN A NEW GLOBAL CONTEXT

Schmiedle, L; Prof.
Dr. Wehner, R.
Otto-Friedrich-University, Bamberg;
University of Applied Sciences Wuerzburg-Schweinfurt

Introduction

International tax avoidance and evasion through the use of tax havens is one of the most important and long-standing concerns of the tax administrations of most OECD Member countries. The use of tax havens by individuals and companies has been increasing over the past decades to the detriment of both, tax revenues and tax morale. As investment decisions are influenced by tax motives, competition is being distorted between those taxpayers who use tax havens and those who do not. Even though countries´ views may differ what activities should be taxed and how, tax authorities of OECD Member countries share the basic concerns that the use of tax havens should not undermine the basic principles of domestic tax systems. Recent debates in this field have led to renewed interest of this phenomenon, which has not only economic consequences but also a deep impact on society in general (Gravelle 2015, p. 19). The biggest companies in the world, like Microsoft, Google and plenty others pay nearly no taxes and hide billions of dollars in tax havens which make people in the western world feel unequal treated (Shah 2013). The damage tax avoidance and tax evasion models cause in developing countries is hard to describe. Necessary investments into the education sector, the health system or the infrastructure are not done and the countries remain underdeveloped and poor. As a consequence people start to emigrate for economic reasons instead of developing economy and society in their home countries. Developed countries suffer as well from the same effects. Missing money for health care or education, cause higher contributions for the individuals. Hence, only members of the upper economic class can afford proper healthcare and high quality education for their children. The lower economic class in those countries is not able to do so. The impacts of this global phenomenon of tax avoiding and tax dodging on the middle class societies are tremendous but not really on the radar (Palan et al. 2010, p. 157). The fact however that modern democracies are based on freedom and middle class societies should bring this group into the center of the global discussion about tax havens. Healthcare, high rents, as well as student loans with extreme interest rates are stressing the middle class through lifetime depts. Claiming responsibility by starting a family or buying property, which are typical indicators of becoming a member of a middle-class society, is not feasible in most cases. Limited or no access to the middle class causes disinterest in political processes and has therefore a deep impact on democracies.

What is a tax haven?

The answer to this question seems to be quite simple. People addressing issues related to tax havens mostly think about Caribbean Islands like Bermuda or the Cayman Islands with very low tax rates or no taxes at all. Even if this is a nice conception, the reality is much more complex. Even nowadays in the attempts being made by INVESTOPIA or other business directories, the term tax haven lacks a clear definition. Despite debates, the number of countries considered to be tax havens has grown significantly since the 1980´s. As tax havens are regularly associated with tax evasion, money laundering, criminality and embezzlement, most tax havens choose the less pejorative designation “Offshore Financial Centre” (OFC). The term offshore can be defined as a legal space that separates the real and the legal location of a transaction with the aim to avoid some or all kinds of regulation (Palan et al. 2010, p. 24). The concept of an OFC, in contrast to tax haven, is more recent. It is used most commonly to characterize financial centers specializing in non-resident financial transactions. This means in practice that an offshore jurisdiction offers people residency in another jurisdiction and the legal opportunity to record transactions in that offshore jurisdiction even though the transaction itself does not really take place there. The parties to the transaction are therefore ‘offshore’ in the sense that they are located outside the country in which the transaction is recorded. Most jurisdictions which can be examined as tax havens have at least some features discussed below. All however suggest minimal or no taxation of income, as well as a high level of secrecy to banking transactions. In addition, many countries possessing tax haven characteristics are often a base for low taxation on diverse classes of perfectly legal income and activities (Gordon 2002, p. 14).

No tax, or very low tax rates

The main purpose in locating the management of passive income or service activities in 'classical' tax havens is to obtain a relative advantage in taxation. Many of the jurisdictions that are considered to be tax havens do impose some taxes. All of them however promise either no income tax or offer a tax rate substantially lower than other countries. The majorities of the low tax countries are small, have little population and are economically not really developed. Therefore, the income of the inhabitants is quite low and a regular taxation of the residents' income is not applicable to finance those states. They usually find other ways, like charging fees for bank licenses, commercial charters and other facilities or services, to create revenues. Also high tax countries are using the system of low taxes for steering political interest. For example, the Netherlands introduced a tax rate of about 5% on income generated by intangible assets to create a more attractive environment for R&D. Compared to the regular corporate income tax rate of 20% - 25% it is a real incentive for companies dealing with IP. Even if it is assumed that this tax law was passed to support the Dutch, in a globalized world it can be legally used by all companies to avoid taxes. Countries like Belgium, Luxemburg and Ireland have similar laws (FinGlobal 2018). Another interesting detail about the no tax or low tax jurisdictions is the fact that quite a lot of them were former colonies of regular taxed countries like Great Britain, the Netherlands or Belgium. Those former colonies are traditionally close, linked over treaty networks and other laws to their colonial power. The so called British Overseas Territories (BOT) are even under the jurisdiction and the sovereignty of the United Kingdom (gov.uk, 2016). Amongst those 'Overseas Territories' are countries like the Cayman Islands, Bermuda or the British Virgin Islands who are well known as Caribbean Paradises but also as low tax countries and are on the list of the world's biggest tax havens. Countries who do not have that heritage of low tax colonies, like the U.S, compensate this disadvantage on the world marked through Free Trade Agreements i.e. with Panama. Besides no or low taxes who definitely play a major role in classifying a country as a tax haven, there are some other important facts to be considered.

Secrecy

One of the most important characteristics of a tax haven is secrecy. Neither corporations nor private individuals who use tax havens are searching transparency or want to publish their tax avoiding schemes. First of all the secrecy of a tax haven needs to be guaranteed by law. That is the reason why countries like Switzerland, the United States or Germany are ranked amongst the top ten tax havens in the world, even if they are known as high tax countries (Financial Secrecy Index, 2015).

In most of the tax havens it has evolved into a standard basis for protecting banking affairs and other financial transactions from divulgence to foreign tax authorities. Some tax havens, like the Cayman Islands have even enacted secrecy or confidentiality provisions and applied penalties for secrecy trespassing. The secrecy provisions affect especially banks, accounting- and law firms. Their employees are bounded to that strict secrecy regulations and have to fear the consequences when breaking it. `

Political and Economic stability

An extremely important condition for those who want to establish their business or private interests in an Offshore Financial Centre is to choose a country that provides both political and economic stability, without a record or potential of any crisis. The jurisdiction does not have to be subject to violent political swings or face the possibility of a military coup, civil disturbances, war or invasion. Quite often, the most positive results in both political and economic stability are achieved by those countries that have retained certain dependency on their former colonial powers like the Caymans, Barbados or the British Virgin Islands. At the same time, many of the offshore tax havens are completely independent democracies, with proven, good track records – like the Seychelles or Singapore. Furthermore the country should have a favorable disposition towards foreign capital particularly by the provision of liberal commercial laws.

Infrastructure

Every tax haven has a perfect infrastructure. Starting with the availability of competent professional advisors, like international banks, accountants and lawyers to communication systems and transport facilities. Classical tax havens typically increase the relative importance of the banking sector and most follow a policy of encouraging offshore banking business. This is done by distinguishing between resident and non-resident banking activity. Generally, non-resident activity does not have reserve requirements, is taxed more lightly and is not subject to foreign exchange or other controls. It also enjoys the guarantees of secrecy discussed above. Beside a huge number of global operating banks the presence of the 'Big Four' accounting firms, as well as international law firms are the obvious indicators of a tax haven. Without their international expertise, no tax haven would ever exist. Moreover, those offshore jurisdictions have superior communication facilities, like widespread, fast internet and the latest satellite technology. A proper infrastructure connecting the tax haven to the world by air or sea is obvious.

No effective information exchange

Usually the governments of tax havens do not sign information exchange treaties. If they do, the delivered information is very limited and mostly very general. The 2009 reform of the French-Swiss tax treaty was part of a number of initiatives to struggle tax evasion on the global scale. The OECD forced tax havens to exchange information with the partner countries on the basis of bilateral tax treaties. With the financial crisis and its negative consequences for the majority of wealthy countries the pressure on tax havens increased and the OECD specified that each tax haven should sign at least 12 treaties to be in compliance. Furthermore the OECD issued a list of 42 noncompliant tax havens. As a result, at the G20 summit in April 2009, countries urged each tax haven to sign a number of information exchange treaties under the threat of economic sanctions. Even if those treaties improved tax collection and increased transparency concerning illicit capital flows they are hard to control because of banking secrecy and other regulations.

Reasons for using tax havens

Before describing how tax havens are used the question why business is done there should be asked. Obviously, it can be assumed, that the low income tax rates provided by tax havens are basic incentives for a company or an individual to shift business to a tax haven. Moreover there are plenty of considerable benefits for the tax subjects which have no significant tax effect. These include confidentiality; absence of currency controls; lack of banking controls, particularly the reserve requirements; high interest rates on bank deposits and low interest rates on borrowing money. Actually in the financial business of today the physical location has no importance anymore. Clearly though, if somebody wants to participate in the Euromarket it can be done from every place in the world. Therefore, the absence of physical presence can also be considered as a substantial argument for starting a business in a tax haven. However, opening a business or shifting parts of a business into a tax haven is a complicated procedure that needs to be accompanied by professional consultants. Particularly by a multinational bank with subsidiaries all over the world and obviously in tax havens, or an international working tax consultant, like the 'Big Four' accounting firms. (Murphy 2011). Beside multinational banks the 'Big Four' accounting firms, which provide the biggest amount of international professional services networks, offering audit, tax consulting, actuarial assumptions, corporate finance, and legal services, have also subsidiary companies in the majority of tax havens. The major reasons why offshore subsidiaries of banks operate in tax havens are making profits by paying less tax, participating in international agreements and assist clients in opening foreign companies and trusts. It is the offshore banking industry who is turning tax havens in the financial centers. British and German banks open offshore branches mainly for foreign trust business, and Swiss banks for paying tax-free interest on deposits of foreign banks without paying taxes in Switzerland.

Patterns of using tax havens

Most individuals and corporations are using tax havens to avoid taxes. Some others are not really interested in the tax benefits but in the bank secrecy and the participation in networks that are professionally designed for hiding money and erase all traces. Even it is hard to distinguish between legal tax avoiding operations and those who are for genuine trade or business purposes, tax havens are often used for illegal transactions. The lack of transparency however helps to keep the shadow on all of the tax haven related businesses.

Shifting of residence into a low or no tax country is one of the eldest possibilities to escape from high taxation in the home country. Even it is much easier to shift residence through the help of modern media, emigration to another country is not preferable unless it really offers better conditions to those left behind. Moreover, the rules of fiscal residence differ a lot between jurisdictions especially for short-term absence. Residents of some high tax countries who try to bypass these rules by changing residence need to assure that they have not only changed the address but also that the management decisions are being made in the tax haven. If they cannot proof this against the tax authorities in their home country nothing changed and they are subject to tax in both countries. The artificial shifting of residence can also cause legal problems because it can be hard for business partners to determine the real place of the residence of a company.

Emigrating or shifting residence therefore is not as easy and needs to be accompanied by highly professional advisers, like the Big Four accounting firms, which are familiar with the civil and fiscal law of the involved countries. They create special tax avoiding schemes which are hard to examine by local tax authorities but highly efficient. Apple, Google, Amazon, Microsoft or Starbucks are only some prominent examples of US companies who use those professional tax schemes of relocation to reduce their taxes on non-US profits to a fraction of the regular rates. At the end of the day those profits end up in a tax havens like the Bermuda's, which i.e. Ireland has special tax agreement with, because it is a former colony and British Overseas Territory (BOT). The relocation tax scheme is not only used by US companies, but also by a huge number of multinational corporations all over the world.

Transfer Pricing

Transfer pricing is a highly efficient way to shift profits into low tax countries. Transfer pricing refers to the pricing set between two related companies in intra-company transactions. Selling goods and services to each other at prices higher or lower than the market prices subsidiaries and affiliates of multinational companies manipulate their intra-company transaction accounts in a way that revenues from a subsidiary in a high taxed country will be transferred to low taxed country. This technic enables a company to reduce their net taxable corporate profits in higher-tax jurisdictions significantly. In the last years the importance of transfer pricing changed significantly. Since intellectual property rights like licenses and patents became a major part of the international business and world trade their role in price manipulations of multinational corporations has been increased (Karkinski, Riedel 2012, p. 176).

An estimated intra-company trade of over 60% of the complete world trade shows the dimension of the transfer pricing system. As a reaction to this system the OECD launched international guidelines based on the arm's length principle. That means that a transfer price should be the same as if the two companies involved were independent companies and not part of the same corporate structure. The arm's length principle, despite its informal sounding name, is found in the OECD Model Tax Convention and is the framework for bilateral treaties between OECD countries, and many non-OECD governments, too (Neighbour 2008, p. 29). The problem of transfer pricing is not a lack of regulations, it is the fact that multinational companies together with their high professional consultants are trying everything to circumvent those regulations. Besides the fact that it is already difficult to find a comparable price for individual Intellectual Property (IP) the following standard tax avoiding scheme appears quite regular. The IP, like the brand, is shifted from the mother company to a subsidiary which is deliberately established in a country with no or very low taxes on license fees. This 'brand holding' company is charging all the other subsidiaries around the world that are using the brand, like the logo on a coffee cup, with license fees for using the brand. Therefore the taxable profits of the subsidiaries in the countries where the coffee is consumed are being reduced and sometimes even turn into losses.

As a consequence the countries where the consumers spent their money have little or no returns in form of taxes. Even if this construction evokes a feeling of illegalness, it is legal. Furthermore it is a perfect example for regular or high tax countries which are used as tax havens because they exempt just one sector of their economy from corporate income tax.

Besides transfer pricing there are plenty other options, like Holding Companies, Conduit Companies or Service and Transport Companies to escape from regular taxation.

Banking

Banks are conducting significant parts of their international business operations through offshore financial centers. That is one of the reasons why they are present in approximately every country of the world, especially in tax havens. It is also a well-known fact that banks are serving their customers' needs and assist them to shift money, to set up companies as well as foreign affiliates of corporations in the tax havens. The use of tax havens by banks is large and growing and, as research published by Action Aid illustrated, banks are still doing a brisk business offshore despite efforts to clean up the industry. For instance, the big four British banks (Barclays, HSBC, Lloyds and RBS) together had 1,649 tax haven subsidiaries – more than half of all their 3,067 overseas subsidiaries. This is just one example and not specific for British banks. The same pattern can be found in Germany, the US, Russia and all the other countries around the world. Therefore, the banking sector can be denominated as the heart of the tax havens. Without this industry tax havens would probably not exist.

Tax avoiding industry

Besides the described legal ways to avoid taxes through the use of tax havens there are plenty more methods of an abusive use. 'Investment companies', 'base companies' or 'tax shelters' are only some synonyms for structures that are only created to shift money from a high tax country to a low tax country. Those tax avoiding schemes are rarely invented by the companies itself. In most cases the idea and the individual program is being sold to them by their accountants, lawyers or bankers. This group of international experienced high professionals was able to create a tax avoiding industry in the past 50 years that became even larger with the growing globalization. The head of that industry are all global operating banks, accounting firms, especially the 'Big Four' and some international law firms which did a great job to find all possible tax loopholes in the local civil or tax laws around the globe. With that knowledge they create tax avoiding schemes and sell them to their clients. From a purely economic view that is a perfect business concept.

Besides supporting the management of the companies to save taxes and present better key-figures, they earn a lot of money by selling the tax avoiding schemes and by coaching the companies through all the steps of the process. From establishing a company in a foreign country, dealing with the local banks and authorities in the tax havens to the declaration of the profits in the residence country. Companies like Amazon, Apple, Google and thousands of other companies save billions of taxes every year. In addition the international banking and consulting industry also increased dramatically in the last centuries. In contrast to the banks, who suffered more through the financial crisis, the accounting and consulting firms seem to face no problems with the tumbling world economy, even if they were involved. How could a listed corporation or a bank turn bankrupt from today to tomorrow? Their annually or quarterly reports have to be audited by chartered accountants. But quite contrary to the banks, who were blamed guilty for the crises, the accounting firms, especially the 'Big Four', gained even more reputation. Nowadays their reputation is as high that they are offered counselling or even key positions in national or international politics, strategic planning boards of national and international (tax) development. Furthermore they are sitting in the revision boards to control this development. Thus their influence on political decisions, especially in the field of accounting and taxation is more than substantial. As a result they do not longer have to search for tax loopholes, they help to create them. Even if there might be a conflict of interests, nobody seems to be interested in. They are a kind of untouchable or, as Prem Sikka, an accounting professor at Essex business school, called them 'The Pin-Stripe mafia' (Sikka 2012). All the bankers, lawyers and accountants however will claim that they do nothing wrong, they follow the law when they design tax avoiding schemes and sell them to their customers. They cannot be blamed to act illegal. But is it legitimate or fair what they do?

Impacts on society

Nobody will doubt about the fact that one of the pillars of a society is a stable economy. But there are other pillars like education, health care, religion, arts and sciences and some others that need to be financed with the money coming out of that economy pillar. Western democratic societies and states therefore developed a system of taxes which is based on the democratic principle of equality. Means, every resident of a country should be treated equal according to the local tax laws. The taxes are used by the governments of the states to provide public services, like infrastructure, education or heath care and develop in this way a middle class society which is the basis for a functioning democracy. Middle class societies define themselves as free and open. People are able to develop themselves, buy property and take over responsibility to the society and the state. This is the status western democracies or the so called 'developed countries' are still facing at the moment. Without governments however, those countries would never have been able to achieve this condition. Even if the idea of paying taxes was never popular, there was a kind of a broad societal understanding that taxes are necessary to keep or enhance the social status. In the past decades, societies have to deal with the global movement that rich individuals and especially multinational companies, like Apple, Google, Microsoft and many others, are trying to do everything to avoid paying taxes. Their responsibility towards the countries they make their profits and to enhance the society as a whole seem to have disappeared. The reasons for this behavior could be multiple; the consequences however are dangerous for developed countries and a threat for modern democracies. The consequences for non-developed or non-democratic countries are even worse because the developments of a middle-class societies as well as democratic movements are blocked and the countries remain autocratic. As already mentioned tax havens don´t come out of the blue, they are being constructed. When in the past the decision to create a tax haven was more or less political motivated and had little influence on the world economy and the society, it turned nowadays into a global industry which is controlled by accountants, bankers and lawyers. They construct them, they create a demand for their clients to use them and they facilitate the mobility of money off-shore. The impact on the world economy and the society meanwhile reached a point that affects the daily life of millions of people. Reports of an estimated $21 to $32 trillion dollars only in 'financial wealth', hidden in tax havens (Henry 2012 p. 5) or up to € 1 trillion Euros of tax losses per year only in the European Union (EU 2016) show the dimension of this global movement. Moreover, the imbalance between the tax rates of companies like Apple, Google, Amazon, and

Microsoft who report tax rates of 1.9% to 3.7% on their non-US profits and regular employees leads to a feeling of unfair treatment and frustration. Everybody who is able to spend money on a tax-avoiding scheme can reduce his taxes. Therefore wealthy individuals and big corporations often have lower tax rates than regular employees (Ely 2016). As a result, paying taxes is depending on the fact whether somebody is able to afford a tax avoiding scheme.

This is a wrong signal for the middle-class society, who cannot afford to pay for those models. These people feel unequally treated when they pay regular taxes to develop the infrastructure, the social security system and the education system. The big international corporations are using all that benefits but do not participate and pay their fair share. The outcomes of this global trend of avoiding taxes are on the one hand a growing number of mega rich individuals and corporations who often hide their wealth in tax havens and on the other hand massive cuts in public services (Oxfam 2018). No country, not even the developed ones are able to finance education, health care or infrastructure without taxes. The consequences for the people are additional fees for services that used to be covered by the state. That has a big impact on the society in total. Whilst the wealthier group is not really affected by paying extra money, the middle class or the economic weak face massive problems to pay extra for public services like education. More and more people need to take loans and face debts sometimes even until the end of their lifetime just to afford a proper education and keep or enhance their societal status. Others who are not able to manage to finance it fall back in society. This leads to an erosion of the middle-class society and to a loss of confidence into the state and the democracies in developed countries. Low birth rates and poor attendance in democratic elections in western societies might be a signal for that. Another not even less concerning indicator for a fading middle-class society is the attitude of today's societies against democratic principles. Nationalistic tendencies as well as narrow-minded agitation can nowadays be found in most of the European countries. Those tendencies might have multiple reasons. Besides the refugee problem people feel economically unsecure and unequal treated in today's society. The British vote to leave the European Union (Brexit) had its reason amongst others in the huge economic inequality between the people living in the City of London and the rest of the country (Jenkins 2016). If the obligation of paying taxes depends on the fact whether somebody is able to buy for himself an expensive tax avoiding scheme, it is in fact unequal treatment. Although the New Economic Reality of avoiding taxes is legal; it is unfair, erodes middle-class and is going to undermine democracies in developed countries. The consequences of tax avoidance and tax evasion for developing countries are even worse. Most of the companies who are doing highly profitable business in developing countries are using professional tax avoiding schemes to shift their profits out offshore. Thus urgent necessary investments in infrastructure, health care, education or other sectors of the society remain undone. Together with joblessness, micro-wages payed by the multinational corporations or dumping prices for agricultural products there is neither personal nor societal development possible.

Conclusion

The above made statements show only a brief inside into the global movement of avoiding taxes by using tax havens. Over the last centuries global organized banks, international lawyers and especially international accounting firms searched tax loopholes in national tax laws and constructed tax-avoiding schemes. Furthermore they established a global network of tax havens to save billions of taxes for their customers, mostly multinational corporations and rich individuals. From a single, only economic point of view they did a great job because they found legal ways to do so. The big picture however shows that those constructions have big negative impacts on the political- and economic stability of countries and the societies in total. Countries need taxes to stabilize and develop their societies. Meanwhile democracies struggle and are unable to provide public services. As a result, the global movement of avoiding or evading taxes causes the erosion of middle-class societies and undermines democracies.

The fact that tax havens play a central role in this tax avoiding and evading schemes induced the EU, OECD, G20 and other international bodies, to draw countermeasures against the harmful usage of tax havens. Transparency through the automatic exchange of 'financial account' information was the main purpose to tackle the rigid financial secrecy of the tax havens. The 'Foreign Account Tax Compliance Act (FATCA)' which was established by the US in 2010 (FATCA 2016) or the set of agreements made by the OECD in its so-called 'Base Erosion and Profit Shifting (BEPS)' plan introduced in 2014 (OECD 2016) are the most important countermeasures to reduce the impact of tax havens.

The first results of those measures might be seen in the near future when Great Britain, who runs the biggest network of tax havens, leaves the European Union. All the advantages concerning double taxation and free trade among European Union members will disappear and Great Britain can not be used as easy as a financial intermediary anymore.

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Summary

Over the past decades, the global use of tax havens increased in a way that international tax avoidance and tax evasion turns out to be one of the biggest concerns of most OECD Member countries. Countries lose a lot of money, which they desperately need to spend on education, health systems, or infrastructure. Furthermore, the citizens feel unequally treated and lose confidence into the political and legal systems of their countries. Taking this into consideration the global movement of avoiding or evading taxes affects the basis of modern democracies by eroding their middle class societies.