RESEARCH METHODOLOGY FOR OFFSHORE COMPANY ACTIVITIES

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Abstract

Using offshore companies as a business model allows businesses worldwide to reduce taxes paid to national budgets. Public authorities show an interest in analysing the economic activities of offshore companies in order to develop methodologies and tools for the control of the scope of activities and of financial flows that do not reach national budgets.

Recent scientific and practical studies and research papers cover some of the aspects of offshore business, i.e. analyse the amount of financial assets hidden in offshore centres, capital inflows to offshore centres, etc.

However, no evidence was found about research concerning the impact of offshore companies on national budgets and public finance. The paper will cover the aforementioned topic.

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Keywords: offshore companies, research methodology, tax reduction, tax evasion.
JEL Classification: F23, F02, F44.

1. Introduction

Recently, trade through offshore centres and its potential harmful impact on non-offshore countries’ economies have reached high levels. Scientific studies on this subject are periodically carried out abroad (Dufey & Bartram, 1997; Hines, 2009; Henry, 2012). These studies and research works by the scholars show that one of the most important tasks of policy makers is to ensure a clear origin of investments in the economy. However, in that regard offshore companies are unpredictable because their real owners are hidden, which makes it difficult to determine the real origin of invested capital.

Since the 1990s several initiatives have been launched against offshore financial centres by the OECD, the G8, and other international organisations in order to eliminate national bank secrecy rules and to increase international co-operation in fighting harmful tax competition of tax havens (Elsayyad & Konrad, 2012). After the Asian financial crisis in 1997-1998 the OECD reported that “governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens to reduce the tax that would otherwise be payable to them”. However, a slow progress has been observed since then. The financial crisis of 2008 again stimulated interest in tax havens, as part of efforts to strengthen the financial system. Tax transparency was the key feature of the G20 Summits of 2008 and 2009. In 2009 the G20 leaders stated that they “agree to take action against non-cooperative jurisdictions, including tax havens”, that they “stand ready to deploy sanctions to protect our public finances and financial systems” and that “the era of banking secrecy is over.” The Lough Erne Declaration of G8 Summit issued on 18 June 2013 continued the theme by putting stress on tax havens secrecy and on disclosing the ownership of shadowy companies (The British Prime Minister at his closing press conference at the G8 Summit, Lough Erne on 18 June 2013 expressed “that tax authorities across the world automatically share information, that companies should know who owns them, tax collectors and law enforcers should be able to get this information easily” and pointed that “tax authorities across the world should automatically share information to fight the scourge of tax evasion”).

In order to assess the current situation in the country, it is necessary to develop an appropriate
methodology making it possible to assess the scope of activities of offshore companies and their impact on the national economy. In doing so, researchers need to understand the peculiarities of offshore companies and consider complex data which often are not publicly available. The article summarizes the preparatory work done in order to establish the methodology and to draft the principle research stages as regards the scope of activities of offshore companies.

The employed methods of research include the systematic comparative and structural analysis of academic economic literature, logical analysis, qualitative and quantitative analysis.

2. Identification of the research scheme

In preparing the research methodology, the identification of research stages and selection of appropriate input data are one of the key issues. The performed analysis provides grounds for designing the scheme of research (see Figure 1).

Figure 1. Research stages

This scheme has identified four stages. In Stage 1, researchers had to identify foreign territories having OFC features relating with the research goal, i.e. offshore financial centres and territories analogous to offshore centres. Stage 2 is designed to compile a list of companies relating to this research and having features pertaining to it. Stage 3 is intended for the establishment of a basis for the taxation of income of the aforementioned companies and grounds for economic calculations in Stages 4. The aim of Stage 4 is to analyse the scope of activity (in terms of import and export) of the companies in question and assess the impact of offshore companies on the national economy. Methods employed during these stages are described below.

Stage 1. Identification of territories with OFC features. Scholars face the problem of identification of offshore financial centres. They agree that the definition strongly relies on the objective of research (Masciandaro, 2008; Dharmapala & Hines, 2009). It is assumed that roughly 40 major tax havens are active in the world today. Regarding Lithuania – in 1997, a list of territories in which taxes are lower than in Lithuania was compiled and 57 countries and territories were put on it (Resolution No 888 of the Government of Lithuania of 4 August 1997 on Types of Taxable Income Received by Foreign State Enterprises Registered in the Countries or Zones of a Favourable Tax Rate from Legal Persons or Enterprises of the Republic of Lithuania which have no Rights of a Legal Person). In 2001 and 2004, the list was updated and now comprises 61 countries and territories but still excludes some zones such as the U.S. State of Delaware and four other territories with OFC features (Latvia, Belarus, Russia and Ukraine). It is evident from the analysis that the research has to examine 65 offshore centres and territories (aforementioned 61 territories plus Latvia, Belarus, Russia, Ukraine, and the USA).

Stage 2. Identification of companies with OFC features. In this stage it is necessary to identify and assess the tax features of an offshore company. After these features have been identified, it is possible to recognise these companies and to assess their potential impact on tax collection. It has been determined that the concept of an offshore company and its status are defined by a special law or another legal act and that, in accordance with general rules, an offshore company has to be a non-resident, which is its main peculiarity. Later this is exploited to avoid
taxes (Gaidelys & Buciunas, 2011).

The structure of offshore business is based on the principles of legal systems – Case law (Anglo-Saxon) and Continental law (Franco-German). The most popular forms of enterprises in Continental law and Case law systems are presented below (Stungys, Galdikas, Venslovas, & Sakalauskas, 2001). Other scholars also identify the legal system of Islands (off-shore centres) (Apel et al., 2002):

<table>
<thead>
<tr>
<th>Island law</th>
<th>Case law</th>
<th>Continental law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual company</td>
<td>Individual company</td>
<td>Individual company</td>
</tr>
<tr>
<td>General partnership</td>
<td>General partnership</td>
<td>General partnership</td>
</tr>
<tr>
<td>Limited partnership</td>
<td>Limited partnership</td>
<td>Limited partnership, partnership</td>
</tr>
<tr>
<td>Private company</td>
<td>Private (close) corporation, private company</td>
<td>Close stock company, joint stock company</td>
</tr>
<tr>
<td>Public company (corporation)</td>
<td>Public company</td>
<td>Public limited company, stock company</td>
</tr>
<tr>
<td>International business company</td>
<td>Limited liability company</td>
<td>International business company</td>
</tr>
</tbody>
</table>

Source: adapted by the authors with reference to Apel et al. (2002); Stungys et al. (2001).

The research focuses on the problem of how to produce a list of companies registered in offshore centres. Solution to the problem – a company registered in the offshore centre has to indicate in the title its limited liability. Limited liability of the company registered in offshore centres often takes the following legal forms: Partnership, Limited Liability Company or stock company. Other forms of offshore companies are: LP – Limited Partnership, IBC – International Business Company, EC – Exempt Certificate, NRC – Non-Resident Company, QC – Qualified Company, PLC – Public Limited Company, Ltd. – Limited Liability Company, Inc. (Incorporated) – limited liability company, popular in the U.S. and elsewhere, Corp. – Corporation, the same as Ltd., LDC – Limited Duration Company, AV (Aruba) – the same as BV, IC – International Company (Gaidelys, 2001).

Authors, such as Stungys, Galdikas, Venslovas and Sakalauskas, maintain that there are many mixed organisations in offshore business having the features of several different traditional types. Generally these are limited liability companies (hereafter – Limited Liability Company, LLC). In October 1992, the USA passed a law that laid foundations for the establishment of companies of LLC type. Registration of this type of companies is permitted in most states in the USA and also in some other offshore jurisdictions. Although such corporations can be registered in the majority of jurisdictions, the companies of LLC type registered in the USA are appreciated by offshore business best. The same authors maintain that in many respects this form is analogous to a partnership and that it boasts a lot of advantages over offshore companies of other types (Stungys et al., 2001). Other authors maintain that LLC type of companies is a hybrid of association and corporation (Pepper, 1999). The companies of LLC type, like corporations, are liable for their debts only by their property and work on the basis of a written contract with the holder (or holders) of the limited liability company, who is not identified (Trocenko & Karmanova, 1995). Recently the companies of LLC type have gained the right to establish corporations.

Other authors are of the opinion that the registration and operational conditions for the companies of LLC type in the USA are different. For example, in the State of Delaware (the USA) they are permitted to unite existing corporations or consolidate them with the companies of LLC type, which are registered in the state of Delaware (Trocenko & Karmanova, 1995). The same authors state that after most states in the USA have changed their legal frameworks the companies of LLC type may be registered in almost all states of the USA.

Economists and policy-makers agree that profit shifting reduces the tax revenue of a target country. Since tax revenue is impacted by OCs directly and indirectly, Stage 3 is introduced. The first phase of this stage involving the authors was an attempt to identify the areas relating with the phenomenon of tax evasion. The analysis has shown that offshore centres offered various action schemes, but they all are aimed at the reduction of a tax rate and (or) tax evasion (Schwarz, 2011). In most cases, this is done through an offshore company using the services of a non-offshore company
when it is based in a state applying higher taxes compared to the offshore company (Gaidelys, Snieska, & Bernatonyte, 2003; Desai et al., 2006). Research into the history and policy of earlier estimations as well as policy makers’ decisions revealed two most important areas to be inspected, i.e. the so-called “capital flight” and “transfer mispricing”.

**Stage 3. Identification of input data and source of information.** The stage aimed to build a list of indicators and variables based on reliable source of information. On the basis of research Stages 1, and 2 the list of indicators was produced. Specific variables in the model, such as country, the number of companies, investments, imports and exports, are annual data. For all indicators and variables, see Table 2.

**Data Sources.** In the next step of this stage it is necessary to identify institutions that have necessary data. Such institutions are the State Tax Inspectorate, the Central Bank, Customs Department, commercial banks, the Department of Statistics, the State Social Insurance Fund Board and private companies that collect information pertaining to business. In most cases data are taken from the Department’s of Statistics database.

**Time periods.** In most cases data about individual indicators are analysed for the entire period 2002-2012, although the available time series sometimes are shorter for a subset of indicators or variables usually because of changes in their collection methodologies or different dates of the outset and termination of data collection.

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Main structural business statistics indicators of foreign-controlled enterprises in Lithuania</td>
<td>State, the legal form of a legal entity, type of economic activities, number of enterprises, year</td>
</tr>
<tr>
<td>Main structural business statistics indicators of Lithuania-controlled enterprise abroad</td>
<td>State, the legal form of a legal entity, type of economic activities, number of enterprises, year</td>
</tr>
<tr>
<td>Foreign direct investments in Lithuania</td>
<td>Investor state, type of economic activities, the legal form of a legal entity, number of enterprises, investments (in litas)), year</td>
</tr>
<tr>
<td>Lithuania’s foreign direct investments (in litas)</td>
<td>State, type of economic activities, number of enterprises, investments (in litas), year</td>
</tr>
<tr>
<td>Exports (in litas)</td>
<td>State, standard international trade classification, year</td>
</tr>
<tr>
<td>Export of goods produced in Lithuania (litas)</td>
<td>State, standard international trade classification, year</td>
</tr>
<tr>
<td>Imports (in litas)</td>
<td>State, standard international trade classification, year</td>
</tr>
<tr>
<td>Financial indicators of foreign-controlled enterprises in Lithuania (revenue, expenditure, profit)</td>
<td>State, the legal form of a legal entity, number of enterprises, year, revenue (in litas), expenditure (in litas), pre-tax profit (in litas)</td>
</tr>
<tr>
<td>Financial indicators of Lithuania-controlled enterprises abroad (revenue, expenditure, profit)</td>
<td>State, number of enterprises, year, revenue (in litas), expenditure (in litas), pre-tax profit (in litas)</td>
</tr>
</tbody>
</table>

The aim of **Stage 4. Estimation of the scope of offshore companies’ impact** was to produce the final results of the research. Building on the stages developed to identify and collect necessary statistics, the last key stage uses a framework to estimate the impact of those offshore-accumulated assets on the national economy over time. This stage focuses on the assets in the economy that have never been measured – private offshore untaxed income and “eroding and growing hole” in the state budget.

**3. Discussion**

One of the main objectives of the use of offshore companies is tax cuts without prejudice to existing legislation, as well as tax evasion in violation of existing laws, and, depending on the objectives of offshore company establishment, avoidance of capital origins.
It is necessary to identify the characteristics of offshore companies and prepare an appropriate methodology for the assessment of taxes paid (and unpaid) by offshore companies.

The research methodology consists of research stages (identification of territories with OFC features, identification of companies with OFC features, identification of the scope of estimates, identification of input data and data sources, estimation of the scope of offshore companies’ impact), indicators and variables, and estimation methods.

References


