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De-offshorization of Economy: Myths and Reality

Review. This article is dedicated to the solution of the issue of returning the capital from offshore back to Russia (de-offshorization). The object of this research is the world offshore centers that provide tax “sanctuary” for the Russian capital. The research focuses on the mechanisms, methods, and tools that would allow returning this capital back into the Russian economy. The article analyzes the causes of appearance of offshore zones and their functional direction, and unravels the notion of offshore business. It further analyzes the main incentives that are offered to the residents of the offshore zones. An evaluation is given to the bases for emerging and the scale of functionality of the global offshore business. The author examines the causes for the capital outflow from Russia into the offshore zones and proposes the organizational-legal measures in order to resolve this problem. The result of this research became the analysis of the causes and consequences of the offshorization of global economic system, assessment of the negative effects of this phenomenon for Russia, and development of number of proposals on de-offshorization of the Russian economy in order to form a comprehensive financial mechanism that would stimulate the development of investment attractiveness of the country.

Keywords: investment attractiveness, de-offshorization, offshorization of economy, tax evasion, tax planning, tax incentives, offshore business, offshore zone, government administration, entrepreneurship.

The modern construct of global economic system has formed in such way that the daily operations on the global currency and financial markets are approximately 50 times greater than the transactions of global trade of merchandise^[1]. The domination of the financial sector over the realistic has served as the main cause of the global economic crisis of 2008. The financial liberalization has led to the fact that the governments genuinely

believed that they must support or earn the trust of the financial markets. In the years preceding the financial crisis, there was a strong inflow of capital into the countries with a developing market economy, which has abruptly run dry in 2008 (illustration 1). Everything seems to suggest that the main reason for this was the uncertainty with regards to possible effects of the financial crisis on the economy of this nations and the resulting desire of the international

Illustration 1. The growth of the global FDI for 2004–2012 and the projection for 2013–2015 in billions of USD ^[3]



investors to reduce their overall risks to a minimum ^[2].

Therefore, the development of international economic relations must be based on a stable financial system that would not only stimulate foreign investments, but also limit the illegal transfer of finances out of the country.

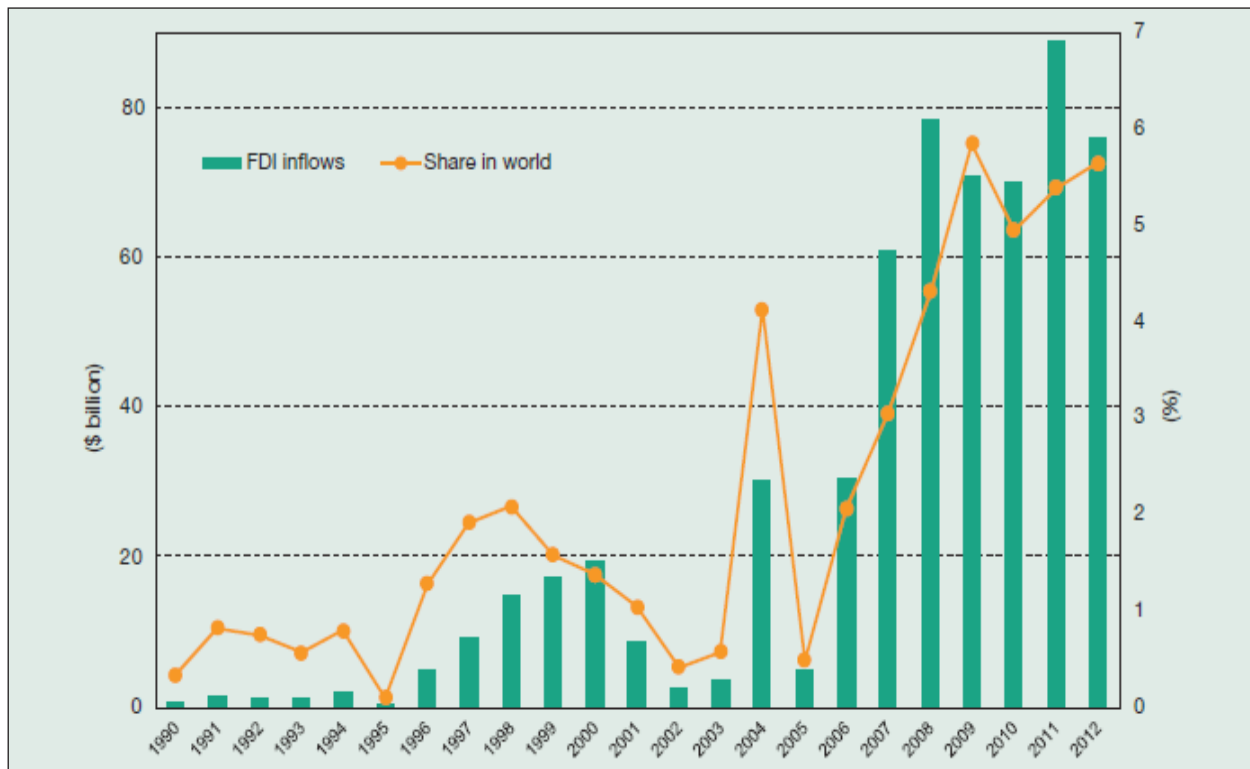
Presently, most of the largest global financial centers have formed within the offshore zones, where the authorities provide substantial incentives for foreign investing and registration of foreign companies, or in other words offshore business. If in 1975 the amount of global commercial cash flow that passed through the offshore zones amounted to about 5%, by the end of 20th century that equaled to about 50%, or half of the global economic activity ^[4]. Based on the statistical data of the Swiss Bank, International Monetary Fund and World Bank the experts analyzed the financial flow of 139 countries for the period from 1990 to 2010, and calculated that the transnational companies, banks and wealthy individuals,

using the gaps in tax legislation of various countries, as of the end of 2010 have accumulated 21 trillion dollars in offshore zones (where China takes the first place with 1.19 trillion dollars, and Russia in second, with 798 billion dollars of illegally transferred capital), which amounts to a quarter of the global GDP.

The main contribution into the forming of the global offshore financial assets was mostly being made by the world renowned transnational companies and banks. Among them are: “UBS”, “Credit Suisse”, “HSBC” (Switzerland); “Deutsche Bank” (Germany); “Bank of America”, “JP Morgan Chase”, “Morgan Stanley”, “Goldman Sachs” (USA); “BNP Paribas” (France); “Wells Fargo”; “Coca-Cola”; “Procter & Gamble”; “General Motors”; “Intel”; “FedEx”; “Sprint” and others. ^[5]

The investments into the offshore zones that demonstrated growth since 2007 have marked the beginning of the financial crisis. Today, they have reached a new historical height. In 2012 they consisted of approximately 80 billion USD per

Illustration 2. The size and portion of the annual inflow of FDI into the offshores during the period of 1990–2012

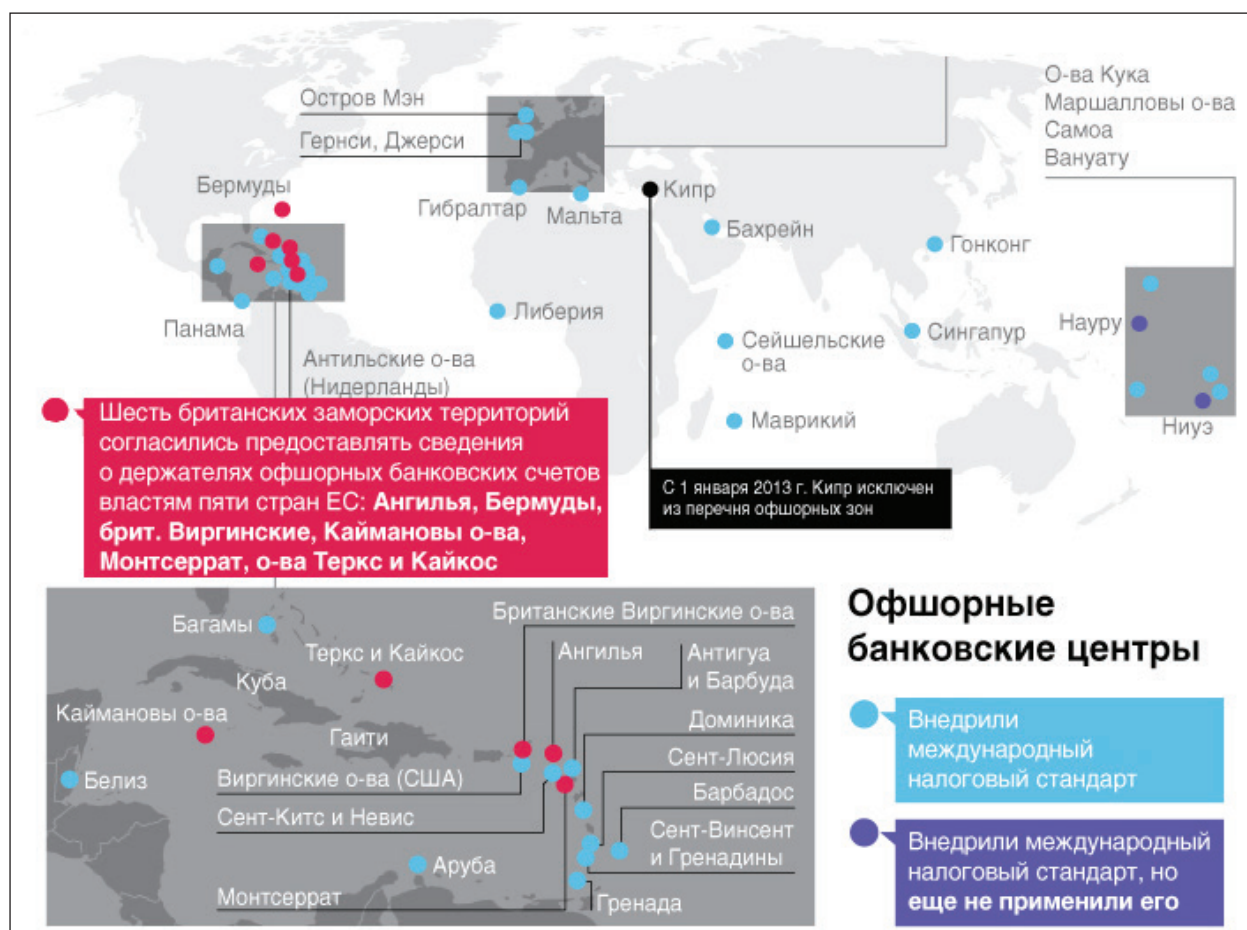


year, which is about 10 billion USD lower than in 2011, but significantly exceed the average annual values that consisted of about 15 billion USD between 2000 and 2006. The offshore portion of investments within the overall amount of global FDI shows a growth of about 6% annually (Illustration 2) [3].

From the financial point of view the offshore zones are typically divided into 3 main types. First type — the subject of economic activity becomes a participant of the offshore zone by paying a one-time registration fee [6]. Second type — the subject of economic activity becomes a participant of the offshore zone by paying recurring dues. According to specialists, such fixed annual fee for an offshore company fluctuates between 150 and 1,000 USD [7]. The third type — the subject of economic activity becomes a participant of the offshore zone by paying taxes a low rate of taxes [8].

Within the modern world we can observe an active competition over the foreign investments. There are over 80 “clean” offshore zones, i.e. countries that specifically create incentivized atmosphere within their territory for international economic activity [9]. The following places are recognized as global offshore centers: Antilles, Bahamas, Caimans, Isle of Man, Barbados, Hong Kong, states of Delaware and Wyoming in the US, Samoa, the islands of Guernsey and Jersey, Ireland, Liberia, Cyprus, Malta, Lebanon, Lichtenstein, Madera, Virgin Islands, Gibraltar, Panama, Singapore, and Switzerland [10].

The global network of offshore centers is spread across continents rather unevenly — 7 offshore centers are located in North America; 25 — in South and Central America; 28 — in Europe; 19 — in Asia; 7 — in Africa; and 14 — in Oceania. This dislocation of the offshore centers demonstrates their gravity towards the three

Illustration 3. Leading global offshore centers ^[12]

leading global financial centers — New York, London, Tokyo, and some regional financial centers ^[11]. Overall, the global network of offshore centers has already been established, although in the future we can expect opening of a few new centers, including in Central America, Oceania, and the republics of the former Soviet Union (Illustration 3).

The analysis of the legislation of separate offshore zones revealed a great variety of the additional opportunities they offer to their investors (Table 1).

Being one of the fastest growing countries, Russia was no exception to the modern tendencies of the global financial sector, which actively uses offshore zones. Russia's active involvement into the international offshore

business began in the 1990's. Throughout the 90's of the last century Russia was leading among the rest of the countries in the number of registered offshore companies. Starting in 1992 anywhere between 2 and 3 thousand Russian offshore companies have been registered each year. Since the beginning of the current century approximately 6,600 accounts of Russian banks have been opened in the offshore zones. Practically none of the profits from the offshore companies ever made it to Russia.

Majority of the Russian entrepreneurs have established offshore firms in the European countries, most of them concentrating on the Isle of Man (UK), Cyprus, Gibraltar, Ireland, Switzerland, and Lichtenstein, where by some estimates between 15 and 20 thousand Russian

Table 1. Incentives for residents of offshore zones ^[12], ^[13]

Type of offshore	The specifics of the provided incentives	Offshores
"Clean" offshores	No taxation of companies registered within the country. High level of confidentiality. No agreements on avoidance of double taxation. No requirement of reporting. "Unprestigious" offshores; threat to revenue investigations.	Anguilla, Bahamas, Bermuda, Republic of Vanuatu, Caiman Islands, Republic of Nauru, Turks and Caicos Islands
Limited offshores without mandatory reporting	No taxation of companies conducting business outside of their jurisdiction. No reporting requirement.	Antigua, British Overseas Territories, Canary Islands, Cook Islands
Limited offshores that require reporting	Incentivized taxation of offshore companies; requirement of reporting. Often provide international double taxation agreements. "Prestigious" offshores.	USA (Delaware), Cyprus
Offshores that offer lower tax bracket for specific types of activity	Specific types of activity are taxed by a lower bracket. As a rule, incentives for banks and holding companies. Often provide international double taxation agreements. "Prestigious" offshores.	Gibraltar, Luxemburg, Gurneys, Jersey, Isle of Man, Austria
Offshores with a territorial principle of taxation	Profits made outside the country are not taxed. Often require detailed reporting.	Hong Kong, Singapore, South Africa, Costa-Rica
Offshores providing some incentives to non-residents	Residents are taxed by a standard set of tax brackets, although companies registered within the country can be considered a non-resident, offering incentives for non-residents and specific types of companies.	UK, New Zealand, Netherlands, Switzerland

Table 2. The trend of the balance of capital outflow from the Russian economy (based on the data from Central Bank of the Russian Federation), in billions of USD

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
-14.4	-3.9	-23.8	-18.2	-21.7	-20.8	-24.8	-15.0	-8.1	-1.9	-8.9	-0.3	43.7	87.8	-133.6	-57.5	-30.8	-81.4	-53.9	-61.0

companies have been registered before the turn of last century.

The outflow of capital is a negative factor that indicates the presence of instability and ineffectiveness of the functionality of the entire economic and financial system. The "capital outflow" from Russia deprives the country of an important source of accumulation of capital, which could in turn be invested into modernization of economy and the process of social and economic rebirth of Russia based on innovational foundation.

Over the last 20 years (194–2014) the combined volume of capital outflow from Russia calculated as a negative balance of the account of operations with capital and financial instruments, amounted to 600 billion USD (Table 2).

During the pivotal phase of the global financial crisis of 2008 a record amount of capital has been transferred out of Russia — almost 134 billion dollars, including over 55 billion dollars through the offshore zones and the offshore commercial banks ^[14]. The pure capital outflow from Russia in 2014 has amounted to 151.5 billion dollars according to the balance of payments presented by the Central Bank of the Russian Federation. In 2013 that same index equaled to 61 billion dollars. Thus, the outflow has increased by 2.5 times. The maximal capital outflow was observed in the 4th quarter of 2014, when the outflow of capital by private sector consisted of 72.9 billion dollars — 4.3 times greater than the same period from the previous year, which was 16.9 billion dollars ^[16]. Acquiring

financing from abroad has been hindered by the events in Ukraine and passing of new sanctions against Russia. This in fact closed the external markets for capital in the second half of 2014. The capital outflow happened in the form of an increase in the dollarization of deposits and the consumer purchasing of the foreign currency due to the elevated foreign economic instability, as well as in the form of paying off foreign debts by the Russian private sector with a limited possibility of refinancing it due to new sanctions.

Based on the long-term prognosis of the Ministry of Economic Development of the Russian Federation the capital outflow can subside by 2017, and by 2020 the inflow of capital can exceed the outflow, which will increase the resource base of the long-term investments.

One of the key motives for using offshore jurisdictions is investing into Russia (reinvesting — “round-tripping”). Using the offshores, some of the money partially return back home, although portion of these investments come back in the form of credits and loans. If we look at the structure of the Russian import and export capital, it will become evident that the active investing is mostly just a mockup — the majority of investments still belong to the offshore zones. For example, the three countries that received the highest volume of FDI from Russia are Cyprus, Netherlands and British Virgin Islands, which coincide with the top-3 investors into the Russian economy.

The President of the Russian Union of Industrialists and Entrepreneurs Alexander Shokhin believes that the outflow of Russian capital into offshores is first and foremost a problem of judicial system of the Russian Federation: “The offshorization of the Russian economy is not just a way of evasion of high taxes, but also protection of property rights. Escape into the English jurisdiction is a way of ensuring protection of the prop-

erty rights. Therefore, even if the tax system will become fairly acceptable, the problem of moving to offshores will still remain.”^[17]. The “foreign” investors with the unfavorable circumstances are trying to protect their investments using the international courts.

There is another point of view on investments from the offshore zones: they can represent a form of withdrawal of the assets overseas when a firm that is registered abroad then purchases (often for a nominal price) a company or the majority of its stock owned by the same person, but registered in the Russian Federation using the funds it has transferred offshore.

In order to change the correlation of factors that affect the escape of capital from Russia it is necessary to enact a number of measures of both economic and legal nature. The very term of “de-offshorization” has entered into the Russian circulation back in 2013, when Vladimir Putin in his address of the Federal Council confirmed the course for the fight against the offshorization of the Russian economy and ordered the government to enact a number of specific measures in this regard. The Russian president emphasized the fact that the Russian authorities should not only “drag” the Russian companies out of offshores using administrative methods, but also create an atmosphere for their return^[18].

To start this process, it is first necessary to drastically improve the conditions for conducting business in Russia. One of the first steps in this direction became the Russian Federation Presidential Decree from May 7th of 2012 #596 “On long-term national economic policy”. It outlined the task of raising the position of the Russian Federation in the rating of the World Bank on the quality of environment for conducting business from 120th place in 2011, to 50th by 2015, and 20th by 2018. Since then, Russia has moved from the 120th place to 112th out of the 185 countries indexed; in

2013 it moved up to the 92nd place; in 2014 to 64th place, and rated for 2015 53rd out of 144 countries ^[19].

However, improving the investment climate is a lengthy process. It is evident that it is possible to improve the stats in separate areas of conducting business; but to drastically change the investment climate in the country, as well as the mentality of the entrepreneurs and officials in the set timeframe is practically impossible. In addition to that, the crisis in Ukraine, changes in the geopolitical situation in the world, new economic sanctions from the leading countries against Russia will also have a negative effect and cause a change in the trend of the index of the environment for conducting business in Russia.

The offshore zones represent a key instrument of tax planning and optimization of paying taxes in Russia. The leading Russian companies that are engaged in the foreign economic activities will continue to use the international tax strategies through the offshore zones as long as the tax systems of various countries differ from one another ^[20]. Therefore, it is necessary to implement the second component — development and application of an effective offshore legislation that would correspond to the current global practice. This legislation would on one hand allow stopping the process of capital outflow from Russia, and on the other — protect the national interests by attracting foreign capital and provide favorable conditions for conducting business for international investors.

It is important to enact a unified federal law “On Offshore Activity” that would contain the definition of the legal status of the offshore zones; the main rules of conducting business through the offshore companies; the order and structure of the specialized financial filing for the Russian companies that are residents of the offshore zones; measures for responsibility for violating the

offshore legislation; list of normative legal acts that are subject to change or abolishment due to the enactment of such law.

It is also necessary to make a number of changes in the Tax Code of the Russian Federation. The development of legislation that would regulate taxation of the controlled foreign companies can prove to be an important component in the fight against tax evasion by the Russian companies using the offshore zones that provide low tax brackets. Within the practice of taxation of some countries we can observe implementation of a rule, where income or part of it that is earned by a foreign subsidiary company and is not distributed amongst the principals (owners) can be taxed as income of its owner (the parent company). This prevents the withdrawal of profits of the parent company into the low tax jurisdictions through its subsidiaries.

In order to introduce the principle of taxation of non-distributed earnings of foreign controlled companies into the legislation it is first necessary to legally define the concept of such company based on determining its principal members and their strategic roles within the organization. Setting the tax rates and taxing the subsidiaries would allow limiting the possibilities for manipulation using the international double taxation agreements by reserving the incentives provided by such agreements only for the actual residents of the country — parties to the agreement.

It is proposed to make it mandatory for the Russian companies or the resident companies to report all their foreign subsidiaries in their tax declarations. The legislation should contain a series of conditions that would justify the commencement of tax responsibility of the Russian tax payers with regards to profits earned by the foreign controlled companies.

The more strict requirements towards reporting the international business deals

and participation of Russian companies in international subsidiary companies should be implemented. It should also be mandatory for the tax payers to provide information on the percentage they own within a controlled foreign company and proof of tax payment for the corresponding percentage of the non-distributed profits of that company. Circumvention of this requirement should be equal to tax evasion and penalized accordingly.

In addition to introducing the norms into the legislation on the controlled foreign companies the department of revenue services should be given the ability to gather the information necessary for effective tax administration, more specifically the following: data identifying the national shareholders of the controlled foreign companies that fall under this legislation, and the financial information needed to calculate the profits they earn.

In order to ensure the transparency of the offshore schemes in the Russian Federation it is necessary to harden the penalties for violations of the tax legislation according to the international practice ^[21].

These measures have been partially enacted on November 24th of 2014 by signing the Federal Law #376-FZ "On amending Parts I and II of the Russian Federation Tax Code (in respect of taxation of the profits of controlled foreign companies)". From the moment of the law coming into effect (from January 1st of 2015, and not before the 1st of the next tax period for each tax) any offshore company with participation of a Russian company must pay corporate taxes of 20%. The non-payment of taxes will carry punishments ranging from 100,000 RUR to criminal liability. However, this does not resolve all of the accumulated problems.

Despite the fact that Russian does not have agreements on exchange of tax information with the offshore zones, there are still viable ways of fighting tax evasion through the capabilities of the national leg-

islation and agreements on international double taxation with the "normal" jurisdictions. The developed Western Countries from 1960's till 1980's also did not have agreements on exchange of information with the offshore zones; however, this did not prevent them from effectively fighting tax evasion. Since Russia is developing a modern market economy, some borrowing of the experience from the European countries and the United States in the area of tax regulation is fairly reasonable and sensible.

Some international agreements on double taxation should also be supplemented by the norms of the national legislation. As an example, the agreements should provide adequate measures for limiting the access to the incentives for those, who are not actual tax residents of the countries (parties to the agreement), as well as providing information exchange according to the national tax legislation.

A great role in limiting the use of the offshore schemes can be played by a legislation that would regulate the inflow of international investments into Russia, especially in the petroleum and mineral industries, where the portion of companies that are controlled by offshore structures through the complex chains of intermediary subsidiaries is rather significant. It is necessary to create a list of industries that would be categorized with regards to allowing foreign offshore investors in the following way:

- Industries within which investments are allowed;
- Industries within which investments are incentivized;
- Industries within which investments are limited;
- Industries within which investments are restricted.

The issue of returning the funds, which have already been transferred into offshores still remains important. As a financial and legal experiment the Russian

business can be offered a tax amnesty for the entire 2015 on return of these funds and their investment into the stimulus of the priority for the current situation high-tech industries: aerospace, bio and nanotechnologies, information technologies, pharmaceuticals, etc.

All such changes within the national economic and foreign economic politics would undoubtedly contribute to the fight against the illegal transfer of capital out of Russia, as well as some legal ways to avoid paying taxes through the offshores.

In conclusion, we can highlight at least four notable achievements of the Russian authorities in the fight against offshorization:

1. Renewal of the tax agreements with the key tax havens for the Russian business

2. Deprivation of right to incentivized taxation for the residents of offshore zones in the cases of strategic ownership

3. Implementation of a mandatory control over the dealings with offshores within the framework the 2011 law on the transfer pricing

4. Success of revenue services in the court arguing of the actions of tax minimizers using foreign companies ^[22].

It will be the effectiveness of the further national policy that would determine whether or not the offshores will turn into supplementing elements of the Russian economic space and contribute to the increase of international competitiveness of the Russian companies, or remain for the most part the “black holes” for the transfer of capital and laundering profits obtained illegally.

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