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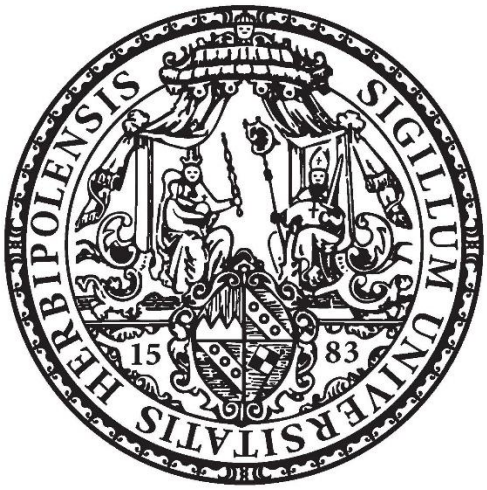

The relevance of tax havens for China

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Table of contents

List of abbreviations

BEPS	Base erosion and profit shifting
BT:	Business tax
BVI:	British Virgin Islands
CCEIO:	Chinese-controlled enterprise incorporated overseas
CFP:	Center for Freedom and Prosperity
CI:	Cayman Islands
CIT:	Corporate income tax
CPC:	Communist Party of China
CSRC:	China's Securities Regulatory Commission
CT:	Consumption tax
DTA:	Double tax agreement
EITL:	Enterprise Income Tax Law
FDI:	Foreign direct investment
HK:	Hong Kong
ICIJ:	International Consortium of Investigative Journalists
IIT:	Individual income tax
MNEs:	Multinational enterprises
MoF:	Ministry of Finance
NPC:	The National's People's Congress
OECD:	Organisation for Economic Co-Operation and Development
OFC:	Offshore financial centres
OFDI:	Outward foreign direct investment
PTR:	Preferential tax regime
SAFE:	State Administration of Foreign Exchange

SASAC:	State-owned Assets Supervision and Administration Commission
SAT:	State Administration of Taxation
SPV:	Special purpose vehicle
TJN:	Tax Justice Network
UNCTAD:	United Nations Conference on Trade and Development
VAT:	Value added tax
WPIP:	Web proof information package
WHT:	Withholding tax

List of tables and figures

Tables:

Figures:

1. Introduction

For the last couple of decades, tax havens have surged and are now as relevant as ever popping up in the media on a nearly daily basis. In January 2016, OXFAM published a report stating that the wealth of the richest 62 individuals is equal to that of the poorest half of the world, which is 3.6 billion people. Referring to findings by Credit Suisse, the richest one per cent owns just as much as the rest of the world combined. Of this wealth US$7.6 trillion are estimated to be held offshore in tax havens. OXFAM accuses the global network of tax havens to facilitate a shift of the tax burden from the most affluent companies and individuals to the poorer and calls for the end of the tax haven era.[1]

National governments have problems collecting taxes from individuals and companies in the increasingly borderless global economy. On the one hand, developing countries need to increase tax rates to promote their economic development driving taxpayers to look for offshore deals, on the other hand governments are inclined to join into a tax race to the bottom to attract companies and stay competitive. The line between what is legal and what is not is blurry since international tax law has not yet caught up with the manifold tax saving opportunities presented by other countries. Big conglomerates like Apple, Amazon or Ikea are being criticised for avoiding taxation at home and are said to fail to contribute their share to the home economy. However, the tax-loopholes and publicly discussed tax planning strategies these companies take advantage of are oftentimes legal.

Western countries have a long history of tax haven involvement. They are the reason tax havens were established in the first place. Countries like the UK have turned their former colonies into tax havens for their own economic benefit. Some countries have turned themselves into tax havens, consider Luxembourg or Switzerland. And the largest bunch of countries has been taking advantage of tax arbitrage ever since. Already in 1987, the OECD identified "international tax avoidance and evasion through the use of tax havens [as] one of the most important and long-standing concern of the tax administrations of most OECD member countries"[2].

Governments of developed countries are increasingly exerting pressure on tax havens to realise transparency and exchange information on owners of bank accounts and holding vehicles. The OECD launched a project called Base erosion and profit shifting (BEPS) which was supposed to introduce tougher regulations and improve tax frameworks. Even though these initiatives are criticised for not delivering promised results, since they have been launched a decreasing demand for tax haven services from Western customers can be

[1]OXFAM 2016: 2, 4-7.
[2]OECD 1987: 20.

identified in some tax havens. Tax havens nevertheless remain big in business. The void is filled to a large extent by Asian investors.

This paper examines the relevance of tax havens for China by determining which tax havens are important for China and to what extent. Furthermore, the motives for Chinese tax haven activity are analysed and compared to the motives of Western companies that primarily use tax havens for the purpose of tax arbitrage. An analysis of two listed Chinese companies, a private and a state-owned entity (SOE), exemplifies how Chinese businesses incorporate tax havens into their business structure and discusses differences between the motives of private and state-owned companies.

The structure of the paper comprises three parts. The first part focuses on tax havens in general. First their historic development is depicted which reveals that tax havens have evolved from being few highly secretive safe havens for rich or criminal people to becoming an omnipresent phenomenon every major corporation resorts to.

The paper goes on to discuss the difficulties when defining the term tax haven and the countries identified as such. As tax havens have no clear-cut definition, this part outlines different attempts at grasping the most important characteristics of tax havens. It is revealed that, despite what the term tax haven insinuates, tax havens offer more than just low or no taxation. Secrecy or lack of information exchange on tax payers are also identified as essential characteristics. It is established that depending on different factors every country can act as a tax havens for taxpayers from other jurisdictions. Furthermore, a closer look at the tag offshore financial centre discloses that the line between tax haven and offshore financial centres (OFC) is blurry. Even though there are some theoretical differences, in practice a trend towards a synonymous use of these two terms can be detected. Different tax haven lists are presented, including the OECD blacklist from 2000 which is discussed in more detail as a lot of critic has been levied against it.

Afterwards, different actors directly involved in tax haven activity and their respective motivation behind tax haven usage are briefly addressed. Identified actors include tax havens themselves, adjacent countries as well as countries whose tax is diverted to tax havens and customers in the form of individuals and corporations. The motivations range from concealing assets and wealth from the government or family members over laundering money deriving from illicit business activities to tax avoidance strategies and the intend to accumulate foreign capital.

As companies that engage in tax haven activity often have the agenda to save taxes, the last part of the chapter explores the concept of tax planning. First the distinctions between the terms tax planning, tax evasion and tax avoidance are established with the result that tax planning refers to legal methods of companies that take advantage of existing tax loopholes.

Subsequently, necessary features for companies engaging in tax planning are introduced. For one, these include the most important taxes, namely corporate and individual income taxes, passive income taxes and withholding taxes (WHT). The problem of double taxation, which entails that taxes are deducted twice during cross-border business, is also addressed. Furthermore, necessary features involve important tax planning instruments as the two most prominent business forms used when companies establish subsidiaries in tax havens, holding companies and offshore trusts. Finally, after the most important factors have been examined, the chapter introduces current popular tax planning strategies.

The third chapter analyses the importance of tax havens in relation to China. The chapter proceeds in the following way. First, China's investment statistics are scrutinised to ascertain the scope of China's tax haven usage on the one hand, and to identify which tax havens are most frequently used on the other. The results reveal that China's investment is highly entangled in tax haven activity. The figures showing China's outward foreign direct investment (OFDI) indicate that Chinese investors highly avail themselves of tax haven jurisdictions either for routing the investment back into China via tax havens or for the purpose of further international investment. Tax haven usage within the scope of foreign direct investment (FDI) into China, is traced back to the Chinese investors that round-trip the money back and to foreign investors that channel their China investment via tax havens. The most important tax havens for China are Hong Kong (HK), the British Virgin Islands (BVI), and the Cayman Islands (CI). This triad of country is highly connected to China related investment and commonly involved in round-trip streams of Chinese residents. Investment data only encompasses direct investments to initial jurisdictions which in China's case are often not the ultimate destination for investment. It is therefore concluded that Chinese investment data is unreliable when trying to understand China's genuine investment streams. It is also assumed that the real amount of tax haven usage might even be higher compared to what the statistics stipulate.

The subsequent part addresses the motives of Chinese businesses, including SOEs and private businesses that engage in tax haven activity. It is revealed that China's weak and restrictive regulatory framework pushes Chinese companies offshore. Private companies are particularly constrained by China's business environment. Access to funding from banks or listings on the domestic stock exchange is often denied. Private businesses therefore incorporate in tax havens to list on foreign stock exchanges and accumulate funding for their business activities. Tax havens, especially former British territories like HK, the BVI and the CI, have a superior institutional framework. This offers advantages to Chinese businesses in the form of accomplished corporate governance or property rights protection. Moreover, international investors are familiar with laws and regulations in former British colonies and thus more inclined to invest there. Researchers conclude that China's tax haven usage differs from that of Western investors in so far as Western countries predominantly use tax havens for tax

arbitrage but in China's case tax havens mainly function as financial intermediaries for foreign investors that want to invest in China or Chinese firms that want access to international capital and escape China's restrictive business environment.

It is however faulty to underestimate the scope and the repercussions of China's illegal tax haven activity. The paper therefore raises the issue of corruption among Chinese officials and links it to China's tax haven activity. It is discussed that despite an ongoing anti-corruption campaign by China's President Xi Jinping, many Chinese officials and successful business moguls are connected to multiple holding companies in the Caribbean. Even though being linked to tax haven activity not necessarily constitutes involvement in capital flight or tax evasion, some of the identified Chinese residents have been convicted for bribery or insider trading. Corruption and tax havens allow rich people to increase their wealth and further promote income inequality, which already is an issue China severely struggles with. If corruption and inequality continue to prevail or even exacerbate, it could have detrimental effects on China's society, economy and threaten the legitimacy of the Chinese government. Therefore, irrespective of if the number of illegal tax haven usage is negligible in comparison to legitimate business activities, it is essential to include illegal tax haven activity when assessing the relevance of tax havens for China.

The following part delivers an overview of the different tax laws and tax rates of China, HK, the BVI and the CI. As Chinese tax haven strategies are analysed for tax liabilities and tax planning incentives, this chapter provides an insight into tax advantages HK, the BVI and the CI offer. The chapter identifies that the China-HK Double tax agreement (DTA) in combination with HK's tax incentives as a tax haven, offer the most favourable tax rates for investment into China. Moreover, it is revealed that Chinese companies tend to incorporate in the BVI and the CI instead of other tax havens, because these two jurisdictions are allowed to list on the US and HK stock exchange and beyond that offer highly flexible business vehicles.

Chapter three concludes with the introduction and analysis of three of China's prominent tax haven strategies. These include round-tripping, onward-journeying and variable interest entity structures. The concept of the strategies is illustrated and tax haven related advantages are outlined. Furthermore, governmental regulations are assessed and implications for the future importance of these strategies are scrutinised.

Round-tripping entails that Chinese residents channel money via a tax haven back into China for domestic business expansion. The motives behind that strategy have altered over the years. Before 2008, investment coming from a tax haven was deemed foreign investment and subject to a favourable tax regime. In 2008 a new tax law took effect and eliminated the tax advantages. Round-tripping nevertheless remained a very important investment strategy. Chinese businesses continued to implement it to accumulate offshore capital. An analysis of investment streams between China and the triad structure including HK, the BVI and the CI

reveals that the promulgation of the new Enterprise Income Tax Law (EITL) has induced that direct money streams from the BVI and the CI to China are decreasing. Instead, investment to China is now increasingly routed via HK. The reason behind this new trend is presumably that investors want to take advantage of the China-HK DTA.

Variable interest entity (VIE) structures allow investors to circumvent Chinese market restrictions. When it comes to FDI, the Chinese government classifies industries into four categories, namely industries for which FDI is encouraged, permitted, restricted and prohibited. Variable interest entities are companies that work in industries blocked for foreign investment, but that nevertheless want to acquire foreign capital. In order to do that they for example give foreign investors access to licences issued only to Chinese companies. This can be accomplished through the variable interest, which refers to the fact that a Chinese domestic company is controlled by foreign investors not through equity but through a complicated arrangement of contracts.[3] This is better captured in the Chinese term for VIE which is 协议控制 (xiéyì kòngzhì) and means control exercised through agreements. VIE structures have however, no legal standing as they are within the grey zone of the Chinese law and can be declared invalid by Chinese regulators. Even though VIEs have grown in popularity over the last 15 years, the many inherent and external risks indicate that this tax haven strategy will very soon lose in importance.

The term onward-journeying refers to companies that use tax havens and OFCs as a platform to raise capital, which is used for further international investment and multinational operations outside of China. The strategy is outlined in two possible scenarios. First onward-journeying with one holding company is addressed. As most special purpose vehicles (SPVs) with Chinese investment are located in HK, the holding company in the first scenario is domiciled there. The second scenario assumes a Chinese business wants to invest in Europa via a holding company in HK and a second one in Luxembourg. This again mirrors a likely construction as Luxembourg is a tax haven that is often used as a platform for investment into Europe. Both scenarios are analysed for possible tax liabilities.

The last chapter applies the findings and insights from the previous chapters to two case study firms, a private and a state-owned Chinese enterprise. The two case study firms made or at least planned to make an IPO on the HK stock exchange and were obliged to publish a web proof information package (WPIP) prior to the IPO. The web proof information packages offer a comprehensive insight into the companies, their business and company structure. Prior to the IPO, both companies reorganised their business structures and integrated multiple tax havens. After a short introduction of the companies, the chapter proceeds in analysing these altered business structures for possible tax haven strategies.

[3]Schiavenza 2014.

The first company is called Excellence Real Estate Group Limited (EREGL). It is a private Chinese property developer. Prior to the reorganisation, the company was incorporated in HK, with solely Chinese operating subsidiaries. During the reorganisation, the group incorporated in the CI and added multiple layers of tax haven to the business structure.

The second company is a state-influenced financial service provider named Far East Horizon Limited (FEHL). The reorganisation of the company is divided into two steps. First the company based in the PRC ultimately wholly owned by a state-owned entity was incorporated in HK. In addition, CI and BVI holding companies were interposed between the HK incorporated company and the SOE parent. A second reorganisation process followed, after which the shareholding structure was altered resulting in three external investors, all of which incorporated in tax havens, sharing ownership of FEHL with the SOE. The company further expanded its business portfolio and acquired the CI holding company FEHL shipping to offer ship leasing and ship brokerage business. To help undertake that business, 78 SPVs located in HK were put under FEHL shipping control.

After the business structures are analysed in more detail, the chapter concludes with a discussion of the findings. The magnitude of tax havens found in the business structures emphasise the importance of tax havens for Chinese companies, irrespective of whether the company is an SOE or private, or conducts its business in China or internationally. While the reasons why the state-influenced company incorporated tax havens into their structure seemed to be related to legitimate business motives, the motives behind the structure of the private company seemed questionable. The sheer number of tax havens as well as the involvement of Deng Jiagui, Xi Jinping's brother in law, further fostered the suspicion that EREGL is involved in illegal tax haven activity including tax evasion and capital flight.

A structural pattern can be identified. Both companies implemented a triad structure involving two holding companies in the BVI and the CI with a HK subsidiary. It is assumed that this triad arrangement is typical for investment into China.

In relation to the triad structure the question arises why a third offshore holding has to be interposed between the CI and HK or the BVI and HK as a double structure would be sufficient to cover tax planning intentions. The following company motives are presumed. Either the triad structure helps conceal the round-tripping motives of the company or controlling shareholding entities that do not want to be linked to the company interpose multiple tax havens to increase the secrecy. Another explanation is related to China's new EITL and suggests that companies that don't want to be identified as Chinese residents for tax purposes try to obscure their linkages to Chinese parent companies.

The assessment furthermore confirms that China's weak institutional framework and restricting business environment is a major push factor and gives companies plenty of

incentive to go offshore. Once China improves its performance, Chinese tax haven activity might decline. On the other hand, once China's economy catches up with those of developed countries, China might simply shift its motives. Chinese companies might continue to engage in tax haven activity, but instead of doing so for the purpose of escaping China's restrictions, they perhaps align their motives with those of developed countries and engage primarily in tax arbitrage.

2. Tax havens

In the literature, there is no coherence in defining what constitutes a tax haven and which countries are officially deemed a tax haven. The term generally evokes the image of illegal money transactions like money laundering or capital flight flowing to deserted offshore islands somewhere in the Caribbean. This image tells only half the story. This chapter first explores the historical development of tax havens and discusses possible characteristics of them. Afterwards, the various uses of tax havens are explained which, despite what the name tax haven might insinuate, go beyond tax saving instruments. The focus of this thesis lies on tax-related motives. A detailed investigation of the non-tax related motives would go beyond the scope of this thesis. The final part of this chapter therefore presents current tax planning strategies employed by multi-national enterprises (MNEs).

2.1. History of tax havens

Even though tax havens are a modern phenomenon, the concept of cities or islands attracting business with favourable tax regimes is far from new and was already known in ancient Greece[4]. Palan et al. divide the development of modern tax havens into three stages.[5]

The first stage starts in 1869 when after having established its "principality's famous casino"[6], Monaco abolished all forms of income tax, which ultimately but unintentionally turned Monaco into the first genuine modern tax haven[7]. The first stage lasted until 1920s and encompassed World War I. During that time, European countries increased taxes to fund war efforts and thus gave affluent businesses and individuals incentive to seek a safe haven for their money.[8]

After World War I and until the 1970s, the second stage saw the rise of a few countries, including Switzerland, adopting favourable tax regimes on purpose to spur their economic development. Switzerland, who already had made a name for itself as the safeguard of French exiled aristocrats' wealth during the French revolution, enhanced its bank secrecy law in 1934.[9] People or institutions that passed on information on bank accounts or account-holders to government agencies, domestic or foreign, were committing a crime.[10] During that time, many dependencies from the British Empire were originally established as booking centres

[4]Eicke 2009: 85.
[5]Palan et al. 2010: 108.
[6]Ibid.
[7]Depending on the literature different countries are introduced as the first tax haven. According to the Tax Justice Network for example Switzerland was the first to acclaim tax haven status when in 1815 the Vienna Congress guaranteed Switzerland neutrality. (TJN 2015b: 2) Eicke starts the tale of tax havens in 1926 when Liechtenstein adopted a new Company Law and introduced a new corporate form called "Anstalt" which could conceal income and property from taxation. (Eicke 2009: 85)
[8]Palan et al. 2010: 108.
[9]Sharman 2006: 22.
[10]Ibid.

for the wholesale market[11]. Financial transactions in wholesale markets are negotiated and arranged in global financial centres like London or Frankfurt, but by officially registering or booking the transaction somewhere else, e.g. in a tax haven jurisdiction, high German or UK taxation and strict regulations on profits could be avoided. This explains, why despite being officially registered in a tax haven, banks conduct their real business and store their assets somewhere else.[12]

The third stage from the 1970s until the late 1990s marks the "golden years"[13] of tax havens. Their number increased immensely, as did the amount of financial assets that passed through them.[14] The reason why many people to date have a pejorative evaluation of tax havens can be dated back to the third phase. The rise of many Caribbean Islands like the Bahamas, Bermuda and the Cayman Islands can to some extent be ascribed to money laundering activities for drug cartels and other organised crime networks.[15] However, these islands maintained low or zero tax rates which resulted in a great demand for their financial services thus enabled the islands' population to attain a high living standard.[16] Especially small island states, often encouraged by former colonial powers, took a leaf out of already established tax havens' books to strategically develop their economy.[17] During the 1980s and 1990s, many Islands followed suit and entered the market for financial offshore services. [18] Among the Caribbean Islands were for example the British Virgin Islands (BVI) and Panama. Among Pacific Islands were the Cook Islands, Samoa or Vanuatu.[19] At that time, first in-depth reports on tax havens were issued, e.g. the Gordon Report for American relations with tax havens in 1981.

To continue where Palan et al. left off, one can divide the years from 1990s until 2015 into two phases. In the fourth phase from the late 1990s until 2013 different institutional actors emerged feeding into the debate on tax havens. Against the backdrop of globalisation and accelerating international trade, tax planning for many multi-national companies turned into a sport, leaving respective governments worried that the tax competition was eroding their nation's tax base. This discussion put tax havens into the spotlight of global politics.[20]

Already in 1987, the OECD identified "international tax avoidance and evasion through the use of tax havens [as] one of the most important and long-standing concern of the tax

[11]Financial markets are divided into retail and wholesale markets. Retail markets focus on individuals and smaller businesses, whereas wholesale financial markets deal with larger institutions, like governments, other financial institutions or public sector organisations. The amount of money handled in financial transactions within the latter is often very high. (Palan et al. 2010: 21)
[12]Palan et al. 2010: 19-21.
[13]Palan et al. 2010: 108.
[14]Ibid.
[15]Sharman 2006: 22-23.
[16]Sharman 2006: 23.
[17]Sharman 2006:21.
[18]Sharman 2006:23.
[19]Ibid.
[20]OECD 1998: 3.

administrations of most OECD member countries"[21]. It was not until 1998 that the OECD, after being pressured by the heads of states of G-7 nations at a meeting in Lyon, France, in 1996, published a report on tax havens that marked the start of the OECD's initiative to curb "harmful tax competition"[22]. The OECD identified over 40 tax havens and threatened those countries that did not commit to OECD standards to punish with defensive measures[23].[24] However, under the Bush administration the US withdrew its support for the OECD initiative and as Sharman argues took the wind out of the OECD's sails[25]. Oxfam among others claims that the initiative on harmful tax competition was also fruitless because other strong OECD members that were tax havens themselves or home to large enterprises blocked progress at that time. In the end, the OECD merely focused on improving information exchange standards for tax havens, withdrew its "name and shame"[26] approach and resorted to less effective measures such as peer pressure and dialogue.[27]

In 1998 and 2003, Attac[28] and the Tax Justice Network (TJN) were launched in France and in the UK respectively.[29] Both associations are examples of left-wing non-governmental organisations that take a stand against tax havens, conduct research and provide information on this issue.[30] At the other end of the spectrum one finds actors arguing for tax havens. One example is the US-based Center for Freedom and Prosperity (CFP). According to Palan et al. this right-wing think tank was established by the Heritage Foundation as a direct response to the OECD initiative of 1998.[31] The CFP celebrates tax competition and low taxation as a manifestation of market liberalisation and interprets the OECD initiative as a group of high-taxing countries trying to shield themselves from economic competition.[32] The CFP is argued to have played a major role in the strategy change of the Republican Bush administration.[33] Before the Bush administration took over in the year 2000, the Clinton administration wanted to improve the transparency of financial flows to tax havens identified by the OECD. At first Bush intended to continue this line of policy, yet changed strategy in 2001 and withdrew support for the OECD project.[34]

[21]OECD 1987: 20.
[22]OECD 1998: 9.
[23]Defensive measures included e.g. to impose WHTs on payments to residents of blacklisted tax havens, to deny income tax conventions with blacklisted Tax havens or to impose additional charges or levies on transactions involving uncooperative tax havens. (OECD 2000: 25)
[24] OECD 2000: 25.
[25]Sharman 2006: 10.
[26]Sullivan 2007.
[27]Ibid.
[28]Attac stands for "association pour la taxation des transactions financières et pour l'action citoyenne".
[29]Attac 2015; TJN 2015.
[30]Palan et al. 2010: 50.
[31]Palan et al. 2010: 227.
[32]Ibid; Mitchell 2009.
[33]Sharman 2006: 61; Palan et al. 2010: 217.
[34]Palan et al. 2010: 217.

Despite drawbacks, the OECD initiative claims to have chalked up some victories. In 2009, Switzerland gave into the pressure from the OECD, France and Germany and loosened its regulations on banking secrecy. In the following years, some major Swiss banks like Credit Suisse, UBS and Julius Bär were investigated by the US department of Justice for facilitating tax evasions. The investigation resulted in said banks having to pay millions of dollars as compensation.[35] In addition to that, 5,000 names of UBS customers guilty of tax evasion were handed over to the US. Starting in 2006, German, British and other European countries' tax authorities bought CDs containing information on tax evaders with bank accounts in Liechtenstein, Switzerland and Luxemburg, countries that at that time still were not cooperating with OECD standards.[36] This led to many voluntary self-incriminations of tax evaders to mitigate punitive damages.

The fifth phase started on April 4th 2013, when the International Consortium of Investigative Journalists (ICIJ), a network of 112 journalists operating in 58 countries,[37] published information on around 120,000 offshore companies and 130,000 individuals from more than 170 countries holding offshore accounts.[38] These leaks are commonly referred to as Offshore-Leaks and represent one of the largest collaborations in journalism history.[39] For more than a year, ICIJ had researched and investigated 2.5 million secret offshore records related to ten offshore centres.[40] Some months after its first publication, ICIJ released a publicly accessible database with more than 100.000 offshore entities in tax havens encouraging the public to search through the found data themselves.[41]

In January 2014, ICIJ started another wave of publications focussing on China, composed of the largest segment of the 2.5 million records.[42] Language barriers had forced the journalists to delay the publication and release of 37,000 offshore clients from China, HK and Taiwan in the Offshore Leaks Database.[43] The fact that among the 22,000 Chinese clients were relatives of high-ranking Chinese politicians, so-called princelings[44], and members of the National People's Congress received much global attention and led in turn to a widespread censorship of ICIJ's publications from various newspapers like Le Monde, The Guardian and Die Süddeutsche in China.[45]

[35]Merten 2014: 12.
[36]Ibid.
[37]Walker Guevara 2013.
[38]Merten 2014: 120.
[39]Gerard et al. 2013.
[40]ICIJ 2013.
[41]Walker Guevara 2013.
[42]Walker Guevara 2014.
[43]Ibid.
[44]Ibid.
[45]Ibid.

At the end of 2014, the publication of agreements that allowed over 300 MNEs, including IKEA and Deutsche Bank, to implement tax avoiding schemes by channelling their profits through Luxembourg became known as LuxLeaks.[46] One wildly discussed example of a company involved in the LuxLeaks is iTunes S.àr.l.[47], one of Apple's subsidiaries, which is located in Luxembourg. During the LuxLeaks in 2014, it was revealed that Luxembourg and Apple had an agreement that Luxembourg would tax Apple's profits at a low rate if Apple in turn would route its transactions through Luxembourg instead of the US, UK or France.[48] In 2011, more than US$1 billion revenue was recorded in Luxembourg "representing roughly 20 per cent of iTunes's worldwide sales"[49].

The most recent Leak series, the SwissLeak, was released in February 2015 and covered the story of the Swiss subsidiary of HSBC being involved with arms dealers and enabling clients, among which were famous actors, politicians, athletes and royalty, to avoid taxation.[50] The global repercussions to the streak of tax secrecy revelations have been immense.

For the OECD, the year 2013 marked its second attempt at curbing tax evasion together with G20 countries. In July 2013, they published a 15-point Action Plan to address Base erosion and profit shifting (BEPS). "Base Erosion and Profit Shifting refers to tax planning strategies [of MNEs] that exploit […] gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid"[51]. Based on this Action Plan, 62 countries, including some developing countries, have helped to prepare a final package of measures to counteract tax avoidance that was published and approved by the OECD and G20 in 2015. The depicted measures now have to be implemented in more than 3,500 bilateral tax treaties.[52] The coming years will show if this challenge can be mastered and the plan on BEPS will be effective.

As can be seen from the historical overview, the role tax havens play for the international economy has changed dramatically over time. They have developed from small European secretive safe havens for few rich and privileged groups, to becoming an omnipresent tax planning tool used by nearly every larger international corporation all around the world. Even though tax havens were already identified as harmful to the global economy over twenty years ago, the conflict of interest among the involved countries has been blocking effective measures ever since. It has to be seen if countermeasures like the BEPS project of the OECD and G20 will be successful in fighting the ever-increasing use of tax havens in the upcoming years.

[46]Fitzgerals/ Walker Guevara 2014.
[47]Abbreviation stands for Societé à responsabilité limitée and means company with limited liability.
[48]Duhigg/ Kocieniewski 2012.
[49]Duhigg/ Kocieniewski 2012.
[50]Ryle 2015.
[51]OECD 2016.
[52]OECD 2015c: 9.

2.2. Tax haven definition

As already mentioned before, there is no clear-cut definition available to describe a tax haven. The concept of tax havens is too wide spread and the countries functioning as tax havens deviate too much from one another for one definition to possibly capture all of their unique features. This chapter introduces different attempts at defining tax haven characteristics and names some of the countries identified as such.

The most prominent tax haven definition and list can be found in the OECD report "Harmful Tax Competition – An emerging Global issue" from 1998. The report offered four key factors to identify a tax haven[53]

1. No or only nominal taxation on the relevant income;
2. Lack of effective exchange of information on taxpayers;
3. Lack of transparency in the operation of legislative, legal or administrative provisions;
4. The jurisdiction does not require a business to undertake substantial activity

The OECD initially looked into 47 jurisdictions but excluded six that according to the OECD did not fulfil the criteria for tax haven. Of the remaining 41 countries that were identified as tax havens, six[54] made advanced commitments to OECD standards and were thus dropped off the list as well. [55] The remaining countries did not agree to cooperate with the OECD and its attempt to curb harmful tax conventions and thus were blacklisted. In the end, the first OECD list was published in the year 2000 and contained 35 countries that are presented in table 1.[56]

Already in 1994 Hines Jr. and Rice published an alternative line-up of 41 tax havens, including some larger and more developed countries like Hong Kong (HK), Switzerland and Ireland which later on were not identified by the OECD.[57] As the economies of the 41 countries differed immensely, the two researchers decided to group the larger countries with a population exceeding one million, the so- called "Big-7"[5859] together and separated them from the smaller jurisdictions, named "dots"[60]. To determine tax haven characteristics, Hines Jr. and Rice resorted to business literature where they identified four qualities that supposedly make countries more desirable for business and attributed them to tax havens. These four qualities are[61]

1. Low corporate or personal tax rates;

[53]OECD 1998: 23.
[54]The six countries that made advanced agreements were Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino. (OECD 2000: 29)
[55]Gravelle 2009: 5.
[56]OECD 2000: 17.
[57]Gravelle 2009: 729.
[58]Hines Jr./ Rice 1994: 3.
[59]The "Big-7" countries include Ireland, Hong Kong, Liberia, Lebanon, Panama, Singapore and Switzerland.
[60]Hines Jr./ Rice 1994:3.
[61]Hines Jr./ Rice 1994: 40.

2. Legislation that supports banking and business secrecy;
3. Advanced communication facilities;
4. Self-promotion as an offshore-centre

As these characteristics again might apply to some countries but fail to encompass all of them, Hines Jr. and Rice find the characterisation ambiguous and conclude that the listing as a tax haven is somewhat arbitrary and relative.[62] Furthermore, they argue that any country can become a tax haven depending on the tax payer, the respective industry or business, the type of investment undertaken or the tax rate existing in the jurisdiction of the taxpayer.

For this reason, other researchers have grouped tax havens according to some additional features. Orlov summarises different clustering in the following way[63]

- Classical tax havens (no or little taxation like the Cayman Islands CI and the Bahamas);
- Tax havens with no tax on income from foreign sources (e.g. HK and Panama);
- Tax havens with special (privileged) tax regimes (e.g. for holding companies like in Luxembourg and Switzerland);
- Treaty tax havens that offer companies a large tax treaty network (e.g. the Netherlands)

Countries within these groups might share this one characteristic but diverge on other issues. This should be taken into account when targeting these havens.[64]

Hines Jr. and Rice suggest that low-tax rates, despite being the dominant factor, do not constitute a tax haven alone.[65] On that note, it has to be stressed that even the purest tax haven with no nominal taxes for foreigners, must collect money somehow to keep the country running. Some countries redistribute the taxation burden from non-residents to residents. This approach is called ring-fencing[66] and is applied by many prominent tax havens like Jersey, The Isle of Man or Liechtenstein, who tax the income of residents but not tax exiles.[67] The UK, the country that has created and still encourages more tax havens than any other country in the world, is sometimes deemed a tax haven for applying the so-called domicile rule.[68] This rule is a ring fencing mechanism because it differentiates between domiciles and residents[69] when it comes to taxation, and exempts the latter group from paying taxes on their global

[62]Ibid.
[63]Orlov 2004: 97; Eicke 2009: 89.
[64]Orlov 2004: 102.
[65]Hines Jr./ Rice 1994: 40.
[66]Palan et al. 2010: 31.
[67]Palan et al. 2010: 31.
[68]Ibid.
[69]people that have immigrated to the UK, reside in the UK but state they wish to return to their country of origin in the future are considered residents instead of domiciles. (Palan et al. 2010: 39)

earnings.[70] Palan et al. capture the above described mechanisms quite well when defining tax havens as

> jurisdictions that deliberately create legislation to ease transactions undertaken by people who are not resident in their domain. Those international transactions are subject to little or no regulation, and the havens usually offer considerably, legally protected secrecy to ensure that they are not linked to those who are undertaking them[71].

All four of the above-mentioned definitions of tax havens give rise to different lists of countries identified as such. There are no two lists completely equivalent to each other, yet there are many overlaps as can be seen in the comparison of the OECD list from the year 2000 and the list by Hines Jr. and Rice from 1994 in table 1.

The OECD list, the most prominent register of tax havens, nowadays consists of three different parts and has changed multiple times since its first publication. [72] The blacklist, holding uncooperative tax havens, diminished over time, as more and more countries made formal commitments to implement OECD's standards of transparency and exchange of information. [73] The last countries that were listed on the blacklist, namely Costa Rica, Malaysia, the Philippines and Uruguay, were moved to the grey list in 2009.[74] The grey list holds countries identified as tax havens and as other financial centres that have agreed to OECD standards but have not implemented them yet. Finally, on the white list one finds countries that have agreed and actually implemented OECD standards.[75]

The OECD blacklist is highly criticised by Sharman. To tackle harmful tax competition, the OECD adopted a double standard when proposing confrontational tactics for the weak non-member states and a collaborative approach for its strong member states like Luxembourg or Switzerland that were not even listed. [76] The fact that countries were threatened to be blacklisted emphasises in Sharman's opinion a strategy of intimidation. Sharman further argues that the OECD blacklist did not dwindle because of the OECD's success. Instead, as already mentioned in the historical overview, the OECD was faced with less enforcement power when the US withdrew its support in 2001. This led to a dilution of OECD's objectives in a way that today the improvement of information exchange is the only requirement for a country to not end up on the blacklist.[77] Sharman thus concludes that the OECD's attack on

[70]Palan et al. 2010: 39
[71]Palan et al. 2010: 21.
[72]Gravelle 2009: 730.
[73]Ibid.
[74]Gravelle 2009: 730; OECD 2015.
[75]Gravelle 2009: 730.
[76]Sharman 2006: 44, 55, 71.
[77]Gravelle 2009: 730.

tax havens was fruitless and that the OECD has "failed in its central goal of preventing tax havens from using tax concessions to attract foreign investment"[78].

Table 1: List of tax havens as identified by the OECD in 2000 and Hines Jr./ Rice in 1994

Andorra, Anguilla, Antigua and Barbuda, Aruba*
Bahamas, Bahrain, Barbados, Belize, Bermuda***, British Virgin Islands
Cayman Islands***, The Channel Islands**, Cook Islands, Cyprus***,
Dominica, Gibraltar, Grenada, Guernsey*, Ireland**, Isle of Man
Hong Kong**, Jersey*, Jordan**, Lebanon**, Liberia, Liechtenstein, Luxembourg**
Macao**, Maldieves, Malta***, Marshall Islands, Monaco, Monteserrat
Nauru*, Netherlands Antilles, Niue*, Panama
Samoa*, Seychelles*, St. Lucia, St. Kitts and Nevis, St. Martin**, St. Vincent and Grenadines, Singapore**, Switzerland**
Tonga*, Turks and Caicos, U.K. Caribbean Islands**, U.S. Virgin Islands*, Vanuatu

Sources: OECD 2000: 17; Hines Jr./ Rice 1994: 178.
*not included in Hines Jr./ Rice in 1994
**not included in OECD list from 2000
***made advanced agreements to OECD requirements and thus taken off the OECD list.

Another obstacle in the OECD lists is that often times the selection of countries is marked as offshore financial centres (OFC) while other authors identify those as tax havens. The OECD recently even showed a tendency to substitute the term tax haven with OFC completely. It is important to note that these two terms are often used synonymously and therefore cause some confusion. The purpose of OFCs in general is to offer financial services and transactions to non-residents.[79] Offshore can refer either to geographical space between two locations or to legislative space between the real location and the legal location.[80] An official definition for the term is offered by the Bank of International Settlements:

> An expression used to describe countries with banking sectors dealing primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy[81]

Tax havens share similar characteristics with OFCs. Yet, one factor that differentiates the two terms from one another is that tax havens offer so called Preferential tax regimes (PTR), that are fiscal subsidies or financial incentives including tax reductions, in an aggressive way. This way, tax havens attract foreign capital from companies that want to take advantage of tax

[78]Sharman 2006: 8.
[79]Palan et al. 2010: 24.
[80]Palan et al. 2010: 21.
[81]Monetary and Economic Department 2012: 54.

avoidance opportunities and lax regulations.[82] These PTR practices have led to increasing "political tension between states and accusations of harmful tax competition, dumping, free riding, and cheating"[83]. Many countries reject the designation tax haven because of its pejorative connotations and prefer a more neutral designation like OFC.[84] As mentioned above, promoting oneself as an OFC is so common among tax havens that Hines Jr. and Rice even identified it as an essential characteristic of tax havens. The prevalent usage of the term OFCs as "a polite reference to tax havens"[85] was also adopted by international organisations like the OECD and the IMF. Orlov supports this trend, as in his opinion the abusive usage of the term tax haven in the media and by political forces hinders an "impartial research and discussion"[86] of this issue.[87] However, this trend might adversely affect the reputation of real OFCs, which soon might not be distinguishable from tax havens anymore.

Another reason for the confusion of the two terms is that some tax havens did expand their services and activities to include offshore financial services. Yet not all tax havens are OFCs and some of the biggest OFCs, like London or Tokyo, are no tax havens.[88] In practice it is often difficult to assess if tax haven activities have evolved beyond sheltering letterbox companies and trusts and have turned into genuine OFCs.[89]

A third reason for the confusion is that the concept of OFCs is so multifaceted that even organisations like the International Monetary Fund (IMF) gave up on trying to define it. The IMF, aware that previous attempts to define OFCs were insufficient, proposed own new definitions over the years which also failed to really grasp the concept of OFCs successfully. In 2008, the IMF eventually abandoned its OFC programme altogether.[90]

One example of a list that ranks tax havens as well as OFCs is the Financial Secrecy Index by the TJN. In November 2015, the TJN published the most recent Financial Secrecy Index, which "ranks jurisdictions according to the level of secrecy and the scale of their offshore financial activities"[91]. TJN found that the top ten most important providers of financial secrecy are Switzerland, HK, the US, Singapore, the CI, Luxembourg, Lebanon, Germany, Bahrain, Dubai, Macao, Japan, Panama, Marshall Islands and the UK.[92]

[82]Palan et al. 2010: 18-19.
[83]Palan et al. 2010: 19.
[84]Palan et al. 2010: 23.
[85]Palan et al. 2010: 24.
[86]Orlov 2004: 97.
[87]Ibid.
[88]Palan et al. 2010: 24.
[89]Palan et al. 2010: 27.
[90]Palan et al. 2010: 23.
[91]TJN 2015.
[92]TJN 2015.

2.3. The use of tax havens

Depending on the perspective, tax havens have very different uses. Among the involved actors are tax havens themselves, adjacent countries, high-taxing countries whose tax income is diverted to tax havens and finally individuals and businesses that make use of tax havens. This part first takes a closer look at the different actors and their motives for offshore accounts. After that it focuses on one particular and dominating motive that is tax reduction.

Tax havens have often denied to intentionally attract tax payers from other countries. Whether or not this is actually true, the offshore business does provide funds for economic development in these countries. This can be seen in the rapid economic development of smaller tax havens. Their economic development is significantly faster compared to the global status quo. From 1982 to 1999 the tax havens grouped together[93] experienced 3.3 per cent annual per capita GDP in contrast to 1.4 per cent annual GDP growth the world experienced on average for the same period.[94] Moreover, trusts and letter-box companies for example provide employment opportunities for locals that can act as official nominees of offshore companies to hide the identity of the true company or trust owner. The increasing political pressure on tax havens from e.g. the OECD and G20 countries has initiated some changes. Tax havens start to improve transparency and information exchange on taxpayers. Switzerland e.g. has adopted a white-money strategy, which stands for Swiss banks' change of course to only administer assets from tax compliant and transparent clients. Subsequently, the number of registered offshore firms from Western companies decreased significantly. In the meantime, a new group of clients from Asia is filling the void.[95] If this trend should further manifest itself, tax havens dependency on Western countries should decrease significantly. Tax havens then might be less likely to comply with OECD standards.

Over the last couple of decades, tax haven activity has flourished. This aroused international criticism and pressure, especially from high-tax countries that feel cheated out of their tax money.[96] Even though tax havens divert tax income from and "may erode the tax bases of high-taxing countries"[97], Hines Jr. finds that tax havens at the same time seem to have a positive influence by stimulating investment activity.[98] A study by Desai et al. from 2005, feeds into Hines Jr. findings and argues that tax havens do not "appear to divert activity from non-havens"[99]. Quite to the contrary, reduced costs and taxes encourage businesses and foreign investors to, on the one hand, increase their investment activity and, on the other hand,

[93]Referring to the Hines and Rice list of tax havens from 1994 stated in chapter 2.2.
[94]Hines Jr. 2006: 66.
[95]Merten 2014: 209.
[96]Hines Jr. 2006: 94.
[97]Hines Jr. 2006: 95.
[98]Ibid.
[99]Desai et al. 2006: 223.

expand their activities to high-taxing countries surrounding tax havens "at levels exceeding those that would persist if tax havens were more costly"[100].[101]

Palan et al. cite the paper "Tax havens of the World" from 1998 by Diamond and Diamond who argue that the main reason why individuals make use of tax havens, is not primarily for tax reasons but to hide their wealth and assets from their own family, spouses or creditors.[102] In fact, many wealthy individuals are known to have adopted numerous techniques to avoid taxation. Some relocate to tax havens for tax purposes. For example, David Beckham relocated to Monaco which imposes no personal taxation. Michael Schumacher now resides in the Swiss canton Waadt paying taxes not on his income, but on his expenses.[103] A recent phenomenon is the "Permanent Tourist"[104] referring to wealthy individuals that have no place of residency. Instead these individuals make sure they are considered tourists and thus are not subject to taxation, lawsuits or persecution.[105] In general, income and profits can either be taxed in the country of residence of the recipient or in the source country where the income is earned.[106] Tax havens offer individuals the opportunity to separate themselves from their country of origin, for instance ensure opacity and secrecy or let actors register in a tax haven to avoid taxation.[107]

Businesses use tax havens for two main reasons. Either they want to increase their profits by reducing the tax bill or they want to hide wealth and assets from certain people or official authorities. Even though we speak of MNEs, every subsidiary is an independent entity when it comes to taxes.[108] And like individuals, companies can be taxed in the jurisdiction where they acquire profits or in the jurisdiction of residence.[109] Either, for example, the US taxes Volkswagen Group on all the profits obtained in the US or the US taxes all the profits the subsidiary Volkswagen Group of America has obtained. The latter taxing method is much more common because the former method entails that every profit has to be pinpointed to a single location which is very difficult.[110] These factors play major roles in tax planning instruments and strategies of MNEs that are presented in the following chapter.

[100]Ibid.
[101]Ibid.
[102]Palan et al. 2010: 23.
[103]Palan 2010: 82.
[104]Palan et al. 2010: 82.
[105]Palan et al. 2010: 82-83.
[106]Palan et al. 2010: 80.
[107]Palan et al. 2010: 80-81.
[108]Palan et al. 2010: 84.
[109]Ibid.
[110]Ibid.

2.4. Tax planning

The main purpose of tax planning is to take advantage of tax rate differences across countries or to minimise a company's profit which is subject to taxation. Companies adopt a wide range of tax saving behaviours that are categorised according to legality and government acceptance. Every company has the right to strategically arrange their business in a way that diminishes tax liability. Companies may make use of tax relief and incentives explicitly offered by different governments. Companies might shift genuine investment to countries with low profit tax through internal transactions, acquire low-taxed companies or deduct interest payments for debt financing from their tax bill.[111] These tax saving methods fall under the category of tax planning, which is in accordance with the law and therefore accepted by governments.[112]

On the other side of the spectrum lies tax evasion. Tax evasion occurs when a company intentionally fails to declare the right amount of income to the tax authority or "makes a claim to offset an expense against taxable income that he or she did not incur or was not allowed to claim for tax purposes"[113].[114] Tax evasion is illegal and prosecuted under criminal law.[115] It often goes hand in hand with other illegal activities like money laundering or smuggling because the income deriving from these activities has to be concealed from official authorities. Among the most prominent case in history is the case of Al Capone, who despite his involvement in numerous criminal activities like murder or drug trafficking, was in the end convicted for tax evasion and money laundering.

Depending on the level of activity of the taxpayer, tax evasion can be further categorised into more or less serious offenses. An offense of omission, if e.g. the taxpayer fails to declare income, is less serious. If, however, the taxpayer goes one step further and makes "false declarations"[116] or hands in "fake invoices"[117], the offense is more serious because it reveals the intent and active engagement of the taxpayer to deceive tax authorities. While the less serious offense is referred to as tax evasion, the more serious offense is declared tax fraud.[118] It has to be considered that definitions and degree of sanctions can vary from country to country.

In between the clear line of legal tax planning and illegal tax evasion lays a grey area referred to as tax avoidance. Tax avoidance is not illegal per se, but not accepted by governments either.[119] An OECD report from 1987 on tax avoidance and evasion finds that tax avoidance

[111]Schreiber 2013: 35.
[112]Merks 2006: 273.
[113]Palan et al. 2010: 9.
[114]Merks 2006: 273; Palan et al. 2010: 9.
[115]Schreiber 2013: 47.
[116]Merks 2006: 273.
[117]Ibid.
[118]Ibid.
[119]Ibid.

schemes in detail may vary from one country to the next, while some general features prevail.[120] Tax avoidance schemes take advantage of loopholes in tax law and use legal provisions in a way not originally intended. It is in the interest of the taxpayer who uses these tax avoidance schemes to keep them secret. Once schemes are publicly discussed administrative measures are often taken and followed by adjustments to the respective tax law to close the loophole. Also considered tax avoidance is when companies establish their arrangements in an artificial way, so that the sole purpose is to save taxes instead of fulfilling legitimate business aims.[121]

A good example of tax avoidance is the "Double Irish with a Dutch Sandwich" technique explained in chapter 2.4.3.8. It is general knowledge that US giants like Google, Facebook and Apple take advantage of European tax hubs like Ireland and the Netherlands to save taxes. The tax avoidance schemes are not accepted by the US government yet not officially deemed illegal, because the companies simply take advantage of loopholes in the respective tax law. The structures of the US conglomerates are not related to the company's business activities, but solely established with tax saving intentions.[122] However, their tax avoidance scheme is general knowledge and has been publicly discussed in the media for a while now. One would expect that the loophole prevailing in the Irish law would have already been closed. Yet the Irish government did not show any intention to do so. Only after years of pressure from OECD member countries, especially the US and the UK, the Irish Minister for Finance, Michael Noonan, announced in October 2014, that the "Double Irish" would no longer be available for new firms setting down in Ireland after January 2015 and will phase out for firms already using this arrangement in 2020.[123] It is safe to assume that Ireland is intentionally attracting the US business because of the employment opportunities for Irish locals. Most recent numbers showed that over 160,000 locals were employed by the US conglomerates, constituting nearly one tenth of Ireland's overall work force.[124]

After having established what the term tax planning entails, the following subchapters will explore how companies exploit tax havens for the purpose of saving taxes. First basic elements are explained, namely the relevant taxes and tax instrument, before current tax planning strategies adopted by companies are depicted.

2.4.1. Relevant taxes

The most relevant taxes for corporations are corporate income tax (CIT), individual income tax (IIT), passive income tax and withholding tax (WHT) on passive income including dividends, interests, royalties and capital gains. Moreover, as cross-border business activities

[120]OECD 1987: 17.
[121]Ibid.
[122]Kang 2013.
[123]Boland, Vincent 2014; Volkery 2014.
[124]Volkery 2014.

involve multiple jurisdictions and tax laws, some taxes apply more than once. Companies are faced continuously with this problem of double taxation, which is why it is discussed in more detail. When it comes to taxation of a company it is important to know that residency plays a decisive role. In most countries, if a company is considered a resident of a country, its domestic as well as its worldwide income is subject to the respective tax law. In countries with no established residency, "only income derived from country sources"[125] is taxed.[126] Apart from residency, the organisational form of an international business can make much of a difference as well. Depending on whether the company is a corporation, branch, partnership or trust, different laws and levels of liability apply.[127] In this thesis the focus lies on corporations.

2.4.1.1. Corporate income tax

Every corporation is a legally distinct entity whose profit is subject to a corporation tax.[128] The corporation tax differs from country to country but is a single fixed rate that is set at a proportional rate.[129] The US charge the highest corporate income tax (CIT) with 35 per cent among the OECD countries in 2015.[130] In contrast, Switzerland has a corporate income rate of 8.5 per cent and Ireland of 12.5 per cent.[131] These numbers only show the central government CIT rate. The actual tax burden for companies can differ immensely depending on the local government CIT rate and other local taxes that can be levied. In Germany, the unified CIT is set at 15 per cent. On top of that comes the solidarity surcharge of 0.825 per cent[132]. In addition, Germany levies a trade tax, called *Gewerbesteuer*, which is "determined by a uniform factor of 3.5%"[133] and multiplies it with a local tax factor that is set individually at at least 200 per cent with no upper limit.[134] Some of the highest tax factors can be found in Munich, 490 per cent, or Düsseldorf, 440 per cent.[135] After taking all these costs into account, the overall average CIT in Germany amounts to 30 per cent.[136]

2.4.1.2. Individual income tax

Individual income tax (IIT) is in so far relevant for companies as a corporation can distribute its after-tax profits as dividends to shareholders. If the shareholder is a natural person he or

[125]Mintz/ Weichenrieder 2010: 15.
[126]Ibid.
[127]Ibid.
[128]Schreiber 2013: 1.
[129]Schreiber 2013: 1; 6.
[130]OECD 2015b.
[131]Ibid.
[132]The solidarity surcharge is 5.5% of the 15% corporation tax. This calculation amounts to 0.825%. (Schreiber 2013: 6)
[133]Schreiber 2013: 6.
[134]Ibid.
[135]Schreiber 2013: 6; IHK 2015.
[136]Schreiber 2013: 6; OECD 2015b.

she obtains profits from capital assets that are subject to IIT.[137] If the shareholder is a business, dividends are considered operating income and are subject to CIT.

2.4.1.3. Taxation of passive income

Dividends, interests, royalties and capital gains qualify as passive income, which points to the fact that the money is earned with little or no effort on the part of the person receiving it. All of the passive income types are subject to withholding taxes (WHT)[138]. Dividends refer to the distribution and allocation of company profit to its shareholders. Interests can derive from deposits, savings or loans. Royalties are charges due when companies make use of for instance technological expertise, designs or other intangible assets like patents or trademarks owned and licensed by another entity. A company obtains capital gains when it sells shares or other equity. The profit deriving from it is taxable.

2.4.1.4. Withholding taxes

To ensure the funding of state operations, a government can withhold taxes. In many countries taxes on employment income are withheld and employees must file for tax return at the end of a year. Interesting for the research question of this thesis is the WHT on passive income applied to non-residents. Cross-border charges like interest, rents, royalties, and employment compensation are subject to WHT to combat tax evasion.[139] In general, the resident state of a company is entitled to levy WHT on the dividends paid to shareholders. In case the resident state of the company and the resident state of the shareholder signed a bilateral tax treaty called Double tax agreement (DTA)[140] based on the OECD's model, the right to tax the dividends in full is normally transferred to the resident state of the shareholder.[141] WHT on interest payments are levied by the resident state of the debtor. The WHT rate can range from ten to 30 per cent. Under a DTA, the WHT can be reduced significantly.[142] The same applies to royalties. The resident state of the licensee levies WHT at a range from ten to 30 per cent, which can be reduced depending on the DTA. Some MNEs might apply a strategy called treaty shopping in this respect, which refers to companies intentionally conducting business activities in jurisdictions that have favourable or multiple DTA's with other countries. If e.g. a conduit company is established in a tax haven or country with favourable tax treaties, the conduit can avoid WHT on the payments the conduit makes to other subsidiaries of the group corporation and on the income and payments the conduit receives from other affiliates.[143]

[137] Schreiber 2013: 1.
[138] See chapter 2.4.1.4. for a more detailed description.
[139] Mintz/ Weichenrieder 2010: 28.
[140] See chapter 2.4.1.5. for a more detailed description.
[141] Wolff 2011: 243.
[142] Ibid.
[143] Mintz/ Weichenrieder 2010: 33.

2.4.1.5. Double taxation

In times of globalisation, most companies eventually have to go global to stay competitive. When companies conduct cross-border business, at least two sovereign states are involved making the whole process of taxation much more complex. For every business transaction, at least two different tax laws and regulations apply. A tax related problem arising from this is called double taxation.

Schreiber distinguishes between economic double taxation and legal or judicial double taxation.[144] Economic double taxation applies when more than one person is taxed on the same tax object, e.g. a company's profit. The profit is taxed once as corporate income of a company and again, after its distribution to the respective shareholder, as dividend.[145] A company can make use of its shareholders, which are often the parent company or other subsidiaries or affiliates, to decrease their tax burden. Instead of distributing dividends that cannot be deducted from a company's profit, the company can "transfer profits to the shareholders via contracts generating deductible expenses"[146].[147] There are several costs that can be deducted from a company's profit. "The most important examples are salaries, rental payments, interest payments and royalties relating to services or capital the shareholders provide to the corporation".[148]

Contrasting the economic double taxation, legal or judicial double taxation applies to situations in which the same company is taxed twice on the same income by more than one state. [149] The possibility for this to happen is strongly related to a country's distinction between residents and non-residents. Residents are subject to unlimited tax liability[150], non-residents to limited tax liability. A company is considered a resident if either their legal seat is in the respective country or their effective management. This methodology is called residence country. If a company only performs some business operations in a foreign country and has no legal personality on site, the company is considered a non-resident and has only limited tax liability in that respective foreign country. This methodology is referred to as source country.[151] Legal double taxation occurs when the profits obtained by a subsidiary can be taxed in the source country and the country of residence at the same time. Legal double taxation can also occur if a company has its legal seat in one country and its place of effective management in another and is therefore considered a resident subject to unlimited tax liability

[144]Schreiber 2013: 13.
[145]Ibid.
[146]Schreiber 2013: 5.
[147]Ibid.
[148]Ibid.
[149]Schreiber 2013: 12.
[150]The worldwide income principle takes effect when a corporation or natural person is subject to unlimited tax liability. This means that the worldwide income of a company or person is taxed in the country of residence. (Schreiber 2013: 12).
[151]Schreiber 2013: 12.

in both jurisdictions.[152] In the reverse scenario, double limited liability, a parent company has two subsidiaries or branches in two foreign countries but is considered a non-resident by both countries. The same income can incur tax liability in both countries when one subsidiary pays the other subsidiary dividends. The income is then taxed twice, once as corporate income of the first subsidiary and once as profit of the second subsidiary.[153]

An instrument to ease the problem of double taxation is DTAs. Most countries make use of bilateral tax treaties "to facilitate cross-border trade, income, and capital flows"[154]. The DTA supports information exchanges between tax authorities and encourages the countries to share tax revenues, which is often accomplished through reductions in WHT rates.[155]

The wording and content of most DTA's derive from the OECD treaty template in the OECD Model Tax Convention on Income and Capital.[156] The OECD model treaty gives the negotiating two countries guidance on how to distribute taxing rights among residence and source country.[157] The model treaty helps define a coherent tax basis for e.g. royalties, dividends or interest. Moreover, it acknowledges, restricts or eliminates taxing rights of source and residence countries in a way that counteracts double taxation.[158]

Two methods for eliminating double taxation are introduced in articles 23 A and B of the OECD model convention of 2014. Article 23 A, which has proven itself popular among EU member states, is the exemption method.[159] The exemption method suggests that foreign income and losses are taxed in the source country and exempt from taxation in the residence country.[160] The second method, suggested in Article 23 B in the OECD model treaty, is called credit method. Under the credit method the country of residence taxes the worldwide income of a company including foreign income which is also taxed in the source country. However, this method allows a company to deduct the foreign tax burden from the domestic tax burden due on that foreign income.[161]

2.4.2. Relevant tax planning instruments

The tax planning instruments presented in this chapter are holding companies, a very particular form of holding companies called international business corporation, as well as offshore trusts. These are the most frequently used vehicles companies adopt when they want to incorporate tax havens into their business structure.

[152]Schreiber 2013: 13.
[153]Ibid.
[154]Mintz/ Weichenrieder 2010: 18.
[155]Ibid.
[156]Schreiber 2013: 14; OECD 2014.
[157]Schreiber 2013: 14.
[158]OECD 2014: 30-32.
[159]Schreiber 2013: 15.
[160]OECD 2014: 36-37; Schreiber 2013: 15.
[161]OECD 2014: 37; Schreiber 2013: 15-16.

2.4.2.1. Holding companies

A holding company is a very popular type of business organisation with multiple tax and non-tax related purposes. As the term holding already suggests, holding companies do not produce products or services but instead are established for the sole purpose of holding assets of other operating companies or partnerships, like voting shares and stocks, which turns the operating companies into subsidiaries of the holding company.[162] The parent firms thus can control and influence the subsidiaries through the interposed holding entity. Holding companies can also hold other assets like trademarks or real estate. Non-tax related purposes of holding companies contain the distribution of risk. Individuals might prefer a holding company to hold their assets, so they personally are not liable for debt or lawsuits.[163] They might also choose to do so to distance themselves and their name from certain assets and instead have a neutral holding company be associated with it.[164] Holding companies can be established in different countries or manage subsidiaries that operate in different markets to decentralise management operations and oversight and improve management quality and organise foreign activities more efficiently.[165] Firms might also choose to use holding companies as in-house banks that lend money to subsidiaries and manage cash funds.[166]

If the holding company's only purpose is to hold shares of subsidiaries, the holding entity is referred to as a special purpose vehicle (SPV). SPVs can function as conduits and are often established offshore in tax havens to take advantage of offshore flexibility and secrecy, to limit liability and to fulfil tax related purposes.[167] Onshore transfer of shares and financing can be difficult and highly regulated. Offshore SPVs can help dodge these hurdles. Foreign investors can sell shares of the SPV to initiate an exit strategy, meaning the transfer of the company ownership to another company or investor. The offshore SPV might also have easier access to international financing and can easier use equity and debt financing tools because of lax regulations in the offshore jurisdiction. A very prominent company form for SPVs is the limited liability company. It functions as an additional corporate veil that helps the investor company protect its assets against claims from onshore debtors. To ensure secrecy, SPVs are often not one- but multi-layered. As for tax optimisation, since the subsidiaries have to pay dividends to the offshore holding company, it is consequently more profitable for a company to locate that holding company in a tax haven. The same goes for liquid assets that earn better profits when parked in tax havens.[168] Some holding companies might be established for the simple purpose of channelling money. The aim is to take advantage of the tax havens profound network of bilateral tax treaties and the resulting more favourable tax treatment.[169]

[162]Investopedia 2015; Wolff 2011: 138.
[163]Investopedia 2015.
[164]Ibid.
[165]Mintz/ Weichenrieder 2010: 6.
[166]Ibid.
[167]Wolff 2011: 138.
[168]Mintz/ Weichenrieder 2010: 6.
[169]OECD 2010: 26; Wolff 2011: 138-139.

Another advantage of SPVs is often associated with the Enron scandal in the US from 2001. Enron had established hundreds of SPVs to hide its debt in those vehicles and keep liabilities from its financial statements in the US. To sum up, holding companies are a powerful and heavily used financing vehicle that is implemented for motives that go beyond tax planning strategies.

2.4.2.2. International business corporations

IBCs are limited liability corporations that onshore are subject to many regulations to protect shareholder rights. Offshore, these regulations do not apply. IBCs therefore are a very popular vehicle to engage in tax haven activity. The IBC is often set up as an "intermediate holding company" [170] and used to register a company's transactions and activities in low-tax countries.[171] The typical offshore IBC often has only one director, or a nominee director, e.g. locals of the host country, who can help conceal the identity of the real company owner.[172] "The IBC is a privately-held corporation possessing a legal personality and able to own assets, including a corporate bank account."[173] This feature is especially attractive in combination with the IBC's ability to transform nationality. The IBC, including its capital assets, takes on the "national identity of the jurisdiction that is home to the IBC registry"[174]. This way the real national identity can be concealed and international sanctions, such as those that were until recently imposed on Iran, can be avoided.[175]

Setting up an IBC costs between US$100 and US$500 but often takes no longer than a day because the IBC can nowadays practically be bought "off the shelf"[176].[177] There is even an option to buy older IBCs, whose incorporation documents may date several years back, from a firm offering corporate registration services.[178] This transaction can help companies that need to prove a long business history of their company.

Furthermore, IBCs have little regulatory obligations and are not or rarely subject to tax. Some tax havens implement indirect ways to collect money from non-residents. They e.g. substitute taxes with other kind of fees like licensing or registration fees. They might also force the foreign IBC to hire local staff and impose employment, customs, duty, and property taxes.[179] However, limited monitoring obligations might offset this. IBCs do not have to keep records or books, nor do they need to "send accounts to regulatory authorities"[180].

[170]Palan et al. 2010: 90.
[171]Palan et al. 2010: 21.
[172]Palan et al. 2010: 85-86.
[173]Vlcek 2014: 539.
[174]Vlcek 2010: 118.
[175]Vlcek 2014: 539.
[176]Palan et al. 2010: 86.
[177]Ibid.
[178]Vlcek 2014: 539.
[179]Palan et al. 2010: 31.
[180]Palan et al. 2010: 86.

International authorities have taken notice of the popularity of IBCs. To counteract artificially deferred income, many tax authorities demand proof for real activity of IBCs.[181] If there is no evidence for substantial business activity, so called controlled foreign corporation rules apply. According to these rules, IBCs will be taxed and regulated as if residing in the company owner's jurisdiction of residence.[182]

IBCs, just like offshore trusts, offer the opportunity to cloak their income into different forms subject to different taxation. Income tax rates are often higher compared to e.g. capital gains tax rates. Thus, income deriving from labour is in general more expensive than income deriving from investment. Additionally, investment income results in dividend payments, whereas income from labour results in salary payments that include social security charges.[183]

2.4.2.3. Offshore trust

Offshore trusts are a common legal arrangement that can serve to conceal the true amount and origin of assets, minimise their taxation and protect assets from creditors or political or economic uncertainty in the home country. An offshore trust is created when assets are transferred to a financial institution that resides in a different jurisdiction than the original owner of the assets. While the original owner is referred to as settlor, the financial institution acts as a trustee, the so-called fiduciary, who becomes the legal owner of the assets. The trustee manages these assets for the beneficiaries of the offshore trust which could include the corporation or person who transferred the assets to the trustee in the first place. As long as no beneficiary is a tax haven resident, the income and assets of the trust are excluded from local taxation. All three involved parties, the settlor, trustee and beneficiary, are bound by a written agreement called trust deed. The trust deed stipulates how funds are distributed and how the trust is managed. Normally the settlor who established the trust must be named in the trust deed. In tax havens, however, this requirement is often dropped, so that the assets cannot be linked to its original owner. Furthermore, offshore trusts are among the strongest asset protection vehicles. The settlor can protect offshore assets even if the settlor becomes subject to legal claims or other liabilities that occur in his place of residency.[184]

2.4.3. Tax planning strategies

After having seen the most important types of taxes and instruments of tax planning this chapter is concerned with current tax planning strategies adopted by MNEs. Identifying these strategies within the realm of legal tax planning, does not rule out the possibility that companies employ them for tax avoidance or tax evasion schemes.

[181]Palan et al. 2010: 87.
[182]Palan et al. 2010: 87.
[183]Palan et al. 2010: 91.
[184]Merten 2014: 209.

2.4.3.1. Double-dipping

Double-dipping, or in more complex cases multiple-dipping, is when "a company is able to deduct multiple times an expense for the same activity"[185]. When companies intentionally employ this as a strategy, they implement indirect financing structures. "Indirect financing structures are a chain of ownership"[186] whereby a parent company invests in the equity or debt issued by an affiliate, and this affiliate in turn invests in equity stocks or intercompany loans of another affiliate". Holding companies play an important role in indirect financing structures. The following example depicts a type of double-dipping behaviour.

A parent company A wants to invest in its subsidiary C. Both are located in high-tax countries. If company A loans money to company C directly, company C could deduct its interest payments from its tax bill, but company A would have to pay high taxes for the interest payment it receives from company. If instead company A takes on a loan from a bank, the high interest company A pays to the bank is deductible from company A's profits. Company A goes on to buy equity of holding company B residing in a tax haven at very low charges. Company B lends the money it receives from company A with high charges to subsidiary C in a high-tax country. Companies A and C each reduce their tax bills. Company A is paying high interest rates for the bank loan and company C pays high charges to company B. Company B obtains high profits but is subject to little or no taxation as it resides in a tax haven.[187]

The Netherlands and Ireland have adopted a tax framework that attracts holding companies involved in this kind of group financing.[188] Germany on the other hand has taken measures to counter these financial structures. Interest deductions of parent companies that have taken on a loan to finance foreign subsidiaries are limited.[189] Moreover, what has to be considered is that passive income, like interest payments from controlled subsidiaries, can be deducted from the tax bill of the debtor but is subject to taxation in the country of the creditor.[190]

2.4.3.2. Corporate inversion

Another popular technique is called inversion and applies when a parent company sets up a subsidiary in a tax haven and transfers corporate ownership over to the subsidiary thus turning that subsidiary into the parent company.[191] The citizenship and tax liability of the overall corporation is eventually altered to that of the tax haven.

One reason for companies to invert corporate ownership is to avoid controlled foreign corporation legislation.[192] Controlled foreign corporation rules apply when a domestic

[185]Mintz/ Weichenrieder 2010: 7.
[186]Mintz/ Weichenrieder 2010: 5.
[187]Palan et al. 2010: 91; Mintz/ Weichenrieder 2010: 7.
[188]Palan et al. 2010: 91.
[189]Mintz/ Weichenrieder 2010: 7.
[190]Ibid.
[191]Palan et al. 2010: 90.
[192]Ibid.

company owns at least 50 per cent of a foreign subsidiary in a low-tax country. Another prerequisite for the application of controlled foreign corporation rules is that "the foreign company earns passive income"[193]. If the domestic resident is suspected to accumulate capital in the foreign low-tax country and to defer its income tax on dividends from the controlled foreign entity, controlled foreign corporation rules take effect.[194] The income of the foreign entity then is considered domestic income and subject to the income tax rate of the shareholder's jurisdiction.[195] Subsequent distribution of the foreign profit as dividends to the domestic parent is then however exempt from further domestic taxation because the profit was already taxed.[196]

Some governments adopt laws to either block tax-haven-parent structures or to make them more expensive. The US for example introduced anti-inversion rules in 2004. Afterwards US companies that used to have a US parent company but were acquired by foreign corporations could still be treated like US-parented firms. This anti-inversion provision applies, when either no considerable business activity can be traced back to the new foreign parent incorporated e.g. in a tax haven or if "at least 80 per cent of the foreign corporation's stock is owned by former owners of the US parent"[197].[198]

2.4.3.3. Re-domiciliation

Throughout the years, tax havens have proven their innovativeness against the increasingly well-equipped arsenal of international tax and regulatory authorities. Re-domiciliation is a new invention that is supported by most tax havens. It allows companies to move their company in a catch-me-if-you-can manner from one tax haven to the next "at the first hint of an inquiry"[199] from tax authorities.[200] The companies itself do not change, but the "statute under which they are registered, the law that governs their regulation, the regulator with responsibility for them, and the place of their registered office"[201] do.

2.4.3.4. Dual residency

Being considered a resident in more than one country can have its benefits. A company can be recognised as a resident in the US and the UK at the same time, because the US considers incorporated companies a resident, whereas the UK determines that effective management and control is what constitutes a resident status.[202] Therefore, a holding company incorporated in the US but managed from the UK is a tax subject in both countries. Endowed with the

[193]Schreiber 2013: 48.
[194]Schreiber 2013: 48.
[195]Ibid.
[196]Schreiber 2013: 48; 88.
[197]Allen/ Morse 2013: 399.
[198]Ibid.
[199]Palan et al. 2010: 88.
[200]Ibid.
[201]Ibid.
[202]Mintz/ Weichenrieder 2010: 16.

rights of a resident, the holding company until recently was entitled to reduce corporate taxes in both countries if the company had incurred losses due to interest expenses or depreciation cost deductions.[203] However, both countries changed their laws to close this loophole and disallowed a loss deduction if it was already claimed in another jurisdiction.[204]

2.4.3.5. Debt financing

Investors have two options when financing a company, equity capital or debt. Debt financing has the advantage that interest payments of the debtor can be deducted from the debtor's taxable income and reduce its tax bill in the end. In case of internal debt financing, where the creditor is a subsidiary and not a bank, it must be taken into consideration that the creditor is taxed on interest income from the debtor. A switch from equity to debt financing is thus only profitable "if the combined tax rate on dividend income is higher than the combined tax rate on interest income"[205].[206] If the shareholder debt financing is out of proportion and suggests an abuse of excessive interest deduction, thin capitalisation rules take effect.[207] Thin capitalisation rules apply when a foreign subsidiary lends money to a domestic company and owns at least 25 per cent of the equity capital. Moreover, a debt-equity ratio restricts debt financing beyond a certain threshold. Among EU member states the debt-equity ratio is set at 3:1 or 4:1.[208] If these conditions are met, the debtor is no longer allowed or only partly allowed to deduct interest payments from its taxable profit.[209]

Not only internal but also external debt financing can reduce a corporation's tax burden. If a company in a high-tax country takes up a loan from an external party, e.g. a bank, it can overall safe taxes if it uses the borrowed capital to e.g. acquire a company in a low-tax country.[210] The interest payments of the domestic company are tax-deductible and yield tax savings that exceed the tax burden on the foreign income in the low-tax country.[211]

2.4.3.6. Transfer pricing and income shifting

"Transfer Pricing is the price companies charge for intra-group, cross-border sales of goods and services"[212]. Intra-firm trade enables a company to shift profits between different legally independent subsidiaries or affiliates. "The majority of MNE-owned IBCs are used for transfer pricing"[213]. The strategy is not problematic if the company adopts the "arm's length principle" from the OECD, which demands that the two parties act as independent entities with their own best interest in mind and price the good or service comparable to market

[203]Mintz/ Weichenrieder 2010: 16.
[204]Ibid.
[205]Schreiber 2013: 33.
[206]Schreiber 2013: 32-33.
[207]Schreiber 2013: 48.
[208]Schreiber 2013: 49.
[209]Schreiber 2013: 48.
[210]Schreiber 2013: 109.
[211]Ibid.
[212]Palan et al. 2010: 68.
[213]Palan et al. 2010: 90.

prices.[214] This way independent companies that offer the same goods or services at market prices can be protected from suffering disadvantages that would occur if prices for intra-group trading were much cheaper.[215]

The problems that arise from transfer pricing are on the one hand that companies deliberately manipulate the prices because they know that it is difficult to assess if the company really did apply the "arm's length principle". Many transactions are very unique and comparable transactions and market prices are hard to come by. It is therefore very difficult to determine if the transaction was at "arm's length" or if it was a transfer mispricing.[216]

An example for transfer mispricing, which resembles the double-dipping scheme depicted in chapter 2.4.3.1., entails that a company selling goods to a tax haven subsidiary under-invoices the value of the product. The tax haven subsidiary in turn sells the product at full value and can make a high profit that is not subject to any or less taxation. If a company imports products from a tax haven, the value of the product is over-invoiced to increase the profit in the tax haven and decrease it in the high-taxing country. Other practices include misreporting quality or quantity of the product to feed into the over- or under-invoicing.[217]

On the other hand, transfer-pricing can lead to income shifting, meaning that a company shifts income from high-tax to low-tax countries. In tax havens, the company can park its money or invest it in financial assets at favourable tax rates.[218] Income shifting can involve intangible assets. Patents, trademarks and other intellectual property rights (IPR) are often owned by one subsidiary of a global group to avoid different tax rates and regulations that apply if the IPR were spread across multiple jurisdictions. Since other subsidiaries have to pay royalties to the owner when using IP, income can be shifted to tax havens when locating the IPR in a tax haven subsidiary. From the taxpayer's perspective, it is very important to channel the income to tax havens while avoiding WHTs. This might require multiple channel countries to route the payment to the final destination.[219]

Subsidiaries can also lease fixed assets like vehicles, machines or real estate to other subsidiaries in exchange for a fee or offer insurance services to other affiliates. Given that two subsidiaries engaging in these kinds of exchanges are located in different jurisdictions and at least one in a tax haven, leasing and insurance offers another way to shift income.[220] It is also possible that the whole transaction is a sham. This means that the exchange of goods or

[214]Lanz/ Miroudot 2011: 25.
[215]Lanz/ Miroudot 2011: 25.
[216]Palan et al. 2010: 69.
[217]Mintz/ Weichenrieder 2010: 33.
[218]Ibid.
[219]OECD 1987: 25, Palan et al. 2010: 90; Mintz/ Weichenrieder 2010: 11.
[220]Mintz/ Weichenrieder 2010: 10.

services never takes place but the payment does. The business transaction is then simulated to shift income to a different jurisdiction.[221]

2.4.3.7. Treaty shopping

The meaning of the term treaty shopping is well captured in the image of a MNE that goes on a shopping spree looking for good tax bargains. Companies try to find suitable conduit countries that offer a range of bilateral tax treaties, low corporate taxes and low WHTs.[222]

If a company in country A wants to establish a subsidiary in country C, but WHTs on dividends from C to A are very high, it lends itself to interpose a third country that has DTA's with both countries A and C. If a subsidiary in country B is interposed it can receive dividends from C and pay dividends to A while both transactions are exempt from WHTs.[223]

2.4.3.8. Double Irish with a Dutch sandwich

The "double Irish with a Dutch Sandwich" is a publicly debated tax avoidance tactic popular with IT companies. The strategy involves that assets, comprising of mostly intellectual property, are easily shifted to low-taxing countries and profits are routed "through Irish subsidiaries and the Netherlands and then to the Caribbean"[224].

A pioneer in creating this strategy was Apple.[225] Even though most value adding takes place in the US, most of Apple's profits are foreign and not taxed in the US. About 70 per cent of Apple's profits are allocated overseas. Apple transfers its profits to an Irish subsidiary. Profits in the US are subject to 35 per cent corporate tax rate compared to only 12.5 per cent in Ireland.[226] Thus routing profits from the US to Ireland minimises Apple's tax burden comprehensively.[227] Moreover, Apple takes advantage of the discrepancies in incorporation rules and tax residency rules between different countries to reduce its tax burden even further. Irish tax law allows companies to be "incorporated in the country without being tax residents"[228] if the de facto management takes place somewhere else.[229] The US on the other hand taxes companies on their worldwide income if they are incorporated in the US. Since Apple's Irish affiliate Apple Operations International (AOI) is incorporated in Ireland but 100 per cent controlled and managed from Apple Inc. in the US, AOI is a stateless company with no responsibilities to file tax returns, pay taxes or keep records.[230] "This is the reason why the shell company [AOI] with zero employees paid no taxes at all on reported profits of US$30

[221]Ibid.
[222]Mintz/ Weichenrieder 2010: 7.
[223]Mintz/ Weichenrieder 2010: 63-64.
[224]Duhigg/ Kocieniewski 2012.
[225]Ibid.
[226]Ibid.
[227]Ibid.
[228]Bolton 2015.
[229]Bolton 2015; Campbell 2014.
[230]Kang 2013; Schwartz/ Duhigg 2013.

billion".[231] The same strategy is applied by another shell company Apple set up in Ireland. The subsidiary called Apple Sales International (ASI) owns Apple's IPR outside of the US. Between 2009 and 2012, ASI alone is said to have shielded at least US$74 billion sales income from the US tax authorities.[232]

The tax-planning strategy works in the following way. As the name "double Irish" already insinuates, the strategy involves two of Apple's Irish subsidiaries that were just introduced. One Irish company is registered in Ireland but headquartered and thus tax resident in the BVI. Even though patents are developed in the US, Apple's US headquarter in California transfers IPR to said Irish subsidiary with headquarter company Baldwin Holdings in the BVI. The first Irish subsidiary pays royalties to the second Irish subsidiary, but not directly. To escape the WHTs that would be levied on direct transfer of royalties, the profits are directed to a Dutch subsidiary first. Due to the DTA between Ireland and the Netherlands cross-border transactions are tax-free.[233] The Dutch subsidiary therefore receives money from one Irish company and transfers it to the other one which explains the latter part of the strategy name "Dutch Sandwich". In the last step, the second Irish subsidiary transfers the received profits to Baldwin Holdings in the BVI.[234] Baldwin Holdings, as it already reveals in its name, is a holding and a brass plate company without any physical office or employees and no tax liability.[235]

A problem that arises for the companies that use this strategy is that when the profits are repatriated back into the US, they become subject to US taxation. A coalition of conglomerates affected by this, lobby for a tax holiday or "repatriation holiday" that would allow profits to be repatriated without incurring taxes.[236]

This "double Irish with a Dutch sandwich" strategy is legal, yet argued to not only disadvantage the US, who feels cheated out of tax revenues, but also many other countries like Germany, France or the UK.[237] The European Commission is currently investigating Apples tax agreement with Ireland.

2.4.3.9. Flags of convenience

The expression flags of convenience or open registration refers to the maritime industry. Irrespective of a company's nationality or headquarter location, an enterprise can register its merchant ships in certain countries and carry that country's flag.[238] The motivations behind

[231]Ibid.
[232]Kang 2013; Palan/ Mangraviti 2016: 434.
[233]Campbell 2014.
[234]Duhigg/ Kocieniewski 2012.
[235]Ibid.
[236]Ibid.
[237]Ibid.
[238]OECD 1987: 26.

this can be lower operational costs or favourable tax rules. Often tax havens exempt the profits deriving from the shipping business from income taxation.[239]

3. The relevance of tax havens for China

When it was revealed that increasing proportions of MNCs conducting IPOs on US stock exchanges were incorporated in tax havens, Allen and Morse conducted a study to prove these MNCs were in fact US companies. Allen and Morse suspected that many US MNCs would incorporate the parent company in tax havens, because they can avoid US taxation even when the company is managed from within the US.[240] The study, which examined over 900 MNCs that conducted IPOs in the US between 1997 and 2010, found that not MNCs headquartered in the US but in fact MNCs headquartered in China and HK were regularly incorporating in tax havens and were the cause for the surge in US IPOs undertaken by companies incorporated in tax havens.[241] This result indicates that tax havens have become increasingly important for China.

After having established some general features of tax haven and tax planning in chapter two, the paper now turns to China to assess the relevance of tax havens for the PRC. First, China's investment streams are analysed to detect the overall importance of tax havens and to identify which tax havens are the most relevant. The subsequent part outlines why Chinese companies, private and state-owned, engage in tax haven activity. Most motives are connected to China's restrictive business environment and weak institutional framework. As the literature on Chinese tax haven activity mainly focuses on legal and genuine business motives and underemphasises illegal business activity, the subsequent chapter attends to the linkages between tax havens and political corruption in China. The paper proceeds by introducing major features of China's tax law as well as the taxes in China's most frequently used tax havens, namely HK, the BVI and the CI. The purpose of this is to lay the groundwork for the analysis of tax liabilities in China's tax haven strategies. The final part of this chapter outlines three frequently used tax haven strategies adopted by Chinese companies. They include round-tripping, variable interest entities and onward-journeying. The concept of the strategies is illustrated and tax haven related advantages are outlined. Furthermore, governmental regulations are assessed and their implications for the future importance of these strategies are scrutinised.

[239] OECD 1987: 26.
[240] Allen/ Morse 2013: 395.
[241] Allen/ Morse 2013: 395, 406, 407, 409, 410.

3.1. Importance of tax havens for China

Ever since the economic opening of China in the late 1970s, FDI[242] into China has surged, promoting China's rapid economic development. According to statistics by United Nations Conference on Trade and Development (UNCTAD), China received more than US$100 billion in the form of FDI in 2008. FDI flows increased until 2014 to US$128,500 billion making China the largest FDI recipient in the world.[243] Yet China's outward foreign direct investment (OFDI) keeps growing even faster than its FDI. From 2013 to 2014, compared to a 4% growth rate of FDI, China's OFDI grew by 15 per cent to US$116 billion and is likely to continue its growth at this pace.[244]

A closer look at the geographical origin and destination of investment that flows in and out of China reveals numerous tax haven countries. This suggest that the real flow of investment is gravely being distorted. In 2012, 59 per cent of China's FDI alone went to HK, followed by the BVI and the CI ranking second and seventh respectively. Other well-known tax havens like Singapore, Samoa and the Netherlands also make it into the top ten of recipients of Chinese investment.[245] Concerning origins of investment into China it is interesting to note that from 2005 to 2013, 66 to 90 per cent of Africa's OFDI to China was channelled through Mauritius, a well-known OFC and tax haven. Most recently, another tax haven, the Seychelles, has developed into a real contender for African FDI to China. In 2005, the Seychelles accounted for less than one per cent of African FDI to China, whereas in 2012 over 26 per cent and in 2013 25 per cent were channelled through the Seychelles to China.[246]

The source for the largest share of Investment from the Oceanic and Pacific Islands is Samoa. Already at the beginning of the millennial, Chinas statistics revealed that Samoa accounts for over 50 per cent of investment from the Oceanic and Pacific Islands to China. Over the years, the share increased reaching 80 per cent in 2013.[247] Samoa is listed among the most secretive tax haven in the Financial Secretive Index of TJN. It is also one of the smallest with a surface of less than 3,000 square kilometres and the number of inhabitants not even reaching 200,000.[248] Yet when it comes to FDI flows from the Oceanic and Pacific Islands to China, Samoa, despite its small size, is second to none. This is quite remarkable considering that larger economies like Australia and New Zealand are in the same category. The numbers also emphasise the outstanding importance of tax havens in satisfying China's demand for capital.

[242]The international terminology for FDI states that a minimum of ten per cent of voting stocks have to be acquired to show a lasting management interest and thus qualify the investment for FDI status. In China FDI is recorded when at least 25 per cent of voting stocks are bought. (Vlcek: 112)
[243]UNCTAD 2015: 41; A4.
[244]Ibid.
[245]UNCTAD 2014a: 1.
[246]NBS 2007 – 2015.
[247]NBS 2003-2015.
[248]Merten 2015: 96.

The top three countries receiving Chinese investment again include HK, the BVI and the CI. In 2012 over 60 per cent of China's OFDI went to this triad of countries. These three countries are known to be heavily involved in Chinese round-trip investment, which is discussed in more detail in chapter 3.5.1. As round-trip investment entails that Chinese domestic capital is rerouted back into China via e.g. HK to promote business expansion within the domestic market not in the international market, round-trip investment should not be considered genuine OFDI.[249]

Yet, it is difficult to estimate how much of China's investment round-trips back in as the official FDI and OFDI figures only show direct investments but not indirect investment via other jurisdictions. The statistics only show the country initially receiving China's registered investment, which is often not the ultimate destination. This could entail that China's FDI to tax havens is much higher than what can be seen in the statistics.[250] One example for actual investor country that do not appear in the official statistics on OFDI to China is Taiwan. Due to the strained relationship between China and Taiwan, the latter is known to e.g. reroute its investment in the Mainland through HK for political reasons. [251] In a working paper of the IMF, the authors Prasad and Wei stipulate that a substantial amount of FDI into China via tax havens can also be associated with companies from Japan, Taiwan, Europe or the US, because they can evade taxes in the source countries otherwise subject to CIT.[252] Until 2006, European investors often used a holding company in Mauritius as an intermediary for investment into China. The China-Mauritius DTA exempted capital gains from WHTs. The treaty was altered in 2006 to only exempt portfolio investment from taxes, thus increasing HK's popularity as an alternative for Mauritius.[253] This finding underlines that China's official data is not reliable when trying to analyse China's genuine investment streams.

3.2. Motives for Chinese tax haven activity

The previous part has revealed that Chinese businesses are heavily involved in tax haven activity, in particular with HK, the CI and BVI. There are several explanations why so many holding companies and trusts in tax havens can be linked to China. This chapter addresses motives why Chinese companies, private and SOE, resort to tax havens.

According to Sutherland et al. "the superior institutional environment found in the Caribbean tax havens and OFCs"[254] is one of the reasons why Chinese companies incorporate there. This explains on the one hand why Chinese companies prefer to register in the CI and BVI instead

[249]Sutherland 2010: 20; Vlcek 2010: 118.
[250]Qiu 2014: 648.
[251]Vlcek 2010: 121.
[252]Prasad/ Wei 2005: 6.
[253]Eicke 2009: 174.
[254]Sutherland et al. 2010: 24.

of other tax havens and on the other hand points out that China's weak institutional framework and restrictive business environment is a major push factor for Chinese companies to resort to tax havens.[255]

The push and pull factors manifest in many different forms. For one, corporate governance in tax havens has a higher quality and reputation compared to China. This on the one hand leads to a company incorporated in the Caribbean or HK having better chances to list on US as well as HK stock exchanges than if the company was incorporated in China. On the other hand, international investors are more inclined to invest in companies that abide by an internationally approved corporate governance regime. Former British colonies like the Caribbean and HK can offer that. Thus, Chinese companies can attract foreign capital more successfully with a subsidiary in the Caribbean or HK than in China.[256]

Furthermore, China's weak property rights and strong government give companies an incentive to go offshore. Chinese companies might choose to conceal their Chinese corporate residency with the help of IBCs established in tax havens, because they are afraid the Chinese government might expropriate them. A foreign corporate residency decreases governmental interference and improves property rights protection for the firm controlled or created via FDI.[257]

In addition, the possibility of tax advantages and access to funding have resulted in companies adopting round-trip activities. The incentives for round-tripping money via tax havens have changed over the years. Until 2008, companies choose to move domestic capital across state borders to tax havens by legal or illegal means, and then round-trip the money back into China to save taxes. When the money was invested back into China it was cloaked as FDI to take advantage of favourable tax rates for foreigners, but the tax advantage was terminated in 2008.

After 2008, the main motive changed from taking advantage of favourable tax treatment to the procurement of international capital and funds. The motive behind private companies raising capital offshore is that they are often denied access to funding in China.[258] In China, many companies who are state-owned or under state influence receive considerable support from the Chinese government. This gives SOEs a competitive advantage over private companies, a fact also reflected in the domestic capital market. Chinese authorities make SOE listings a priority thus disadvantaging non-SOE companies that have a hard time accessing this kind of funding.[259] Thus, private firms and other non-SOE companies incorporate offshore to access overseas financing and avoid restrictive regulations of Chinese stock exchanges. A similar

[255]Sutherland 2010: 6.
[256]Allen/ Morse 2013: 410-411.
[257]Sutherland 2010: 6; Vlcek 2010: 120.
[258]Sutherland 2010: 6.
[259]Wolff 2011: 22.

reasoning holds true for financing through bank loans. As most banks in China are also state-owned, private companies are subject to discrimination when they apply for loans. With both funding options, stock market and bank loans, blocked, non-SOEs embrace the possibilities offered offshore.[260]

On a related note, the term onward-journeying, coined by Sutherland,[261] refers to companies using OFCs and tax havens as a platform to raise capital which is used for further international investment and multinational operations outside of China. Chinese companies might prefer to conduct investment from a tax haven than from China because they are faced with a non-transparent and restrictive regime of regulations and provisions.[262] Multiple authorities are involved in the approval process of outbound investment and the companies are ultimately depending on the goodwill of the respective governmental staff. Conducting outbound investment when the company resides in a tax haven is much easier.

Sutherland concludes that, in respect to China, tax havens and OFCs are not necessarily harmful. Sutherland finds they play a legitimate role, "as they enable economic activity to occur which otherwise could not"[263]. It is noteworthy that tax incentives, together with the above-mentioned financing and investing facilitations, unintentionally push companies offshore contributing to the Chinese economy's internationalisation. The establishment in tax havens and OFC can therefore also be viewed as a platform for further international expansion of Chinese companies.[264] Vlcek argues that OFCs and tax havens have developed from a platform used for tax arbitrage, escaping capital controls and financial regulations to international intermediate economies between the global banks and developed countries. Especially in respect to investment flows from and to China he finds it faulty to simply project the historical functions of tax havens for Western countries onto China. Instead he stipulates that especially the "Caribbean Islands function more as a provider of financial intermediation services independent of tax arbitrage for the firms investing in China, and for Chinese firms seeking investment capital"[265] and thereby play an important role in the rapid development of the Chinese economy.

3.3. Repercussions of China's tax haven activity

In addition to that, Sutherland and Vlcek emphasise that in contrast to Western countries, China predominantly avails itself of tax havens for legitimate business purposes like capital acquisition. What both researchers fail to acknowledge is that China has a long ongoing

[260]Qiu 2014: 649.
[261]Sutherland 2010: 4.
[262]Wolff 2011: 13.
[263]Sutherland 2010: 21.
[264]Ibid.
[265]Vlcek 2014: 543.

problem with corruption among government officials. A problem tax havens are directly connected to. Tax havens serve as conduits for bribes and payoffs addressed to well-connected party cadres.[266] When considering that China shows a trend of increasing tax havens usage, it can be assumed that a certain percentage of this increased tax haven activity is a manifestation of corruption activities. It therefore appears faulty to conclude that tax havens are not at all harmful but rather beneficial to China economic development.

The Chinese government has for a long time been accused of turning a blind eye to the involvement of government officials in corruption and capital flight. The real magnitude of entanglement of high ranking cadres, also called the Red Nobility, in tax haven conduits was exposed in the China Leaks from 2014. They revealed that China's political elite and at least 16 of China's richest people were taking advantage of the BVI's offshore anonymity.[267] The ICIJ could not provide information on how the offshore companies were eventually used. Therefore, solely being linked to tax haven companies does not automatically imply that illegal activity has been conducted. What however fosters the suspicion is that Chinese officials and their families are not required to disclose their finances publicly, which allows them to avoid the attention of the public eye and provides them with opportunities to use tax havens for tax evasion or capital flight.[268] Furthermore, cases of elite members who own tax haven companies and were convicted for bribery suggest the interlinkage. One example for this is Huang Guangyu, who was identified as one of the 16 richest Chinese in the China Leaks and together with his spouse owned a complex network of over 30 companies in the BVI. In 2010, he was convicted for bribery and insider trading and sentenced to 14 years in prison.

Xi Jinping launched an anti-corruption campaign back in 2012 right after his elevation to General Secretary of the Communist Party of China (CPC). Around 100 high ranking officials were targeted until 2015. Accusations ranged from insider trading to bribery.[269] As of July 2014, Guangdong Province stated to have identified more than 2,000 officials who have shifted money abroad, 800 of which were already let go. In an article from the South China Morning Post from 2014 the People's Bank of China (PBOC) was said to implement stricter regulations. Those regulations entailed that more responsibility was transferred to banks who were asked to assess the probability that their customers are involved in money-laundering or terrorism-funding. Furthermore, the PBOC since then tries to collect information from different sources, like banks or tax authorities, to improve supervision of customer activities.[270]

[266]Vlcek 2010: 127-128.
[267]Bell 2014.
[268]Ibid.
[269]Lau 2015.
[270]Weinland 2014.

In the light of Xi Jinping's extensive efforts it is surprising that China recently hit the headlines because of its poor performance in tackling corruption. A report by Transparency International evaluated the G20 countries concerning transparency over the real ownership of assets in trust or corporate vehicles. China performed very poorly in uncovering the true identity of beneficiaries of offshore trusts. This allows secretive companies to launder funds deriving from illegal activity without supervision and ramifications. The report concludes that China does not comply with G20 principles and needs to act urgently.[271] China's bad performance despite extensive anti-corruption measures begs the question, if the title of the Transparency International report: "Just for show?" holds true for Xi Jinping's efforts. Considering the repercussions of Xi Jinping's campaign and the number of officials that were supposedly let go, it appears to be a genuine attempt in curbing corruption. A probable reason, why Xi's efforts fail to trigger major or sustainable changes might be that the government tries to cure itself. HK on the other hand, despite its geographical cultural ties to the mainland, has successfully dammed corruption issues. The corruption perception index of Transparency International ranks countries based on how corrupt the country is perceived to be. While China ranks only 83rd place out of 168 countries, HK ranks on place 18th together with Ireland.[272] HK was troubled with major corruption issues 40 years ago, but successfully curbed corruption by enacting the Independent Commission Against Corruption Ordinance. The Commission keeps government influence to a minimum and is scrutinised by independent committees comprising leading citizens and non-officials.[273] In China however, the government tries to cure itself, which might explain the campaign's limited success so far.

Considering that China has strong capital control and foreign exchange regulations, the question arises how Chinese officials circumvent these obstacles when they channel money out of the country. Merten offers some insights. A common strategy of money laundering is to channel money in the form of payment to Switzerland for tax counselling services. Merten points out that this strategy is too easily revealed by now. He argues that derivatives as a financial instrument to channel illicit money into legal money streams are more likely these days. One example of such methods is the weather derivative, where people can bet money on temperature developments in certain jurisdictions. If a Chinese official wants to launder bribe money to Switzerland, he can bet the money with a trade partner. In China, he bets that very unlikely temperatures will occur in Germany while at the same time in Switzerland he bets on the opposite. The Chinese official will lose the amount of bribe money to the trade partner in China but wins the exact amount back in Switzerland. After some additional formalities to conceal the money and its true origin, the money can be invested in Switzerland.[274]

[271]Maira/ Murphy 2015: 10.
[272]TI 2015a; TI 2015b.
[273]GovHK 2015.
[274]Merten 2014: 208.

With China's rapid development to becoming the second largest economy in the world, China has also turned into one of the most unequal economies. According to a working paper by the IMF, China's exacerbating inequality can be attributed to the "faster income growth among the rich, rather than stagnant living standards among the poor"[275]. This observation is very much in line with the findings of OXFAM's recent report stating that tax havens are the root of the increasing inequality. This suggests that also in China's case, tax havens play a major role in promoting inequality. Even though initial income disparity was accepted in the beginning of China's opening-up strategy[276] if these income disparities linger on, they could have detrimental effects for China's society, economic growth and threaten the legitimacy of the CPC.[277]

A recent example of a Chinese civil movement group visualises the growing pressure on China's government in this context.[278] The recently formed New Citizens Movement inspired by Xu Zhiyong demands increasing financial transparency of the country's elites and curbing corruption which already led to countermeasures by the Chinese government to smother the movement.

"International journalists reporting from within the country on the wealth of China's political elite have faced immigration difficulties from the government, or trouble with authorities"[279]. Members of the movement as well as the founder Xu himself have been arrested.[280] At the beginning of 2014, Xu was sentenced to four years in prison for "gathering a crowd to disturb public order"[281].

3.4. Tax regimes in the relevant countries

To assess tax related motives and China's tax haven strategies, this part introduces tax regimes in China and its most frequently used tax havens, namely HK, the BVI and the CI.

3.4.1. China

In China, at the central level the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) promulgate the PRC tax policies. At the local level, there are also more than one administration agency in charge of tax collection, the state tax bureaus and the local tax bureaus.[282] Depending on the kind of tax, e.g. value added or business tax, enterprises are

[275]Cevik/ Correa-Caro 2015: 3.
[276]Deng Xiaoping marked the beginning of the opening up reform in 1979 with his often recited statement "Let some people get rich first". (Cevik/ Correa-Caro: 3)
[277]Cevik/ Correa-Caro 2015: 3.
[278]Ball 2014.
[279]Ibid.
[280]Ibid.
[281]Kaiman 2014.
[282]Wolff 2011: 81.

supervised by one or the other authority.[283] China's tax law is characterised by a lack of comprehensiveness and uniformity and by constant changes. Instead of a general tax code there is a basic law for each type of tax. From time to time supplementary tax circulars are published to clarify questions raised at the local level or to handle issues not yet covered in the basic law. Moreover, local authorities have their own interpretation of laws which is why the application and enforcement at the local level diverges immensely.[284] Finally, China's tax law is constantly changing due to the rapid pace of economic development, which makes it even harder for businesses to keep up. China's tax system comprises three categories of taxes, namely income taxes, turnover taxes and property taxes. Income taxes are divided into CIT and IIT. The group of turnover taxes entails value added tax (VAT), business tax (BT) and consumption tax (CT). Stamp duty, deed tax, land appreciation tax, real estate tax and resource tax are considered property taxes and rather collected at the local level.[285] The following part will focus on the taxes relevant for cross-border investment of Chinese companies.

CIT applies to all enterprises and organisations that receive income, except for sole proprietorship enterprises and partnership enterprises.[286] The taxable income consists of profits, capital gains and passive income such as interest, royalties, rents and dividends from foreign entities. Dividends received from another resident enterprise are exempt from taxation.[287] Before 2008 the tax system followed a dualistic approach distinguishing between domestic enterprises and foreign companies While CIT rates were "nominally the same at an aggregated rate of 33 percent, [foreign-invested and foreign enterprises] enjoy[ed] preferential tax treatment in the form of tax incentives or tax holidays"[288].

On March 16, 2007, the Enterprise Income Tax Law (EITL) was passed and took effect on January 1, 2008. The EITL was passed to align Chinese law with international norms. Before the EITL, the income taxation system distinguished between FIEs and enterprises completely funded by domestic investment. After the law was passed, China adopted the classification of residency and non-residency enterprises. Entities considered a resident are either incorporated in China or have the place of effective management there.[289] Subsidiaries established overseas are also considered subjects to Chinese taxation if the subsidiaries are controlled and managed from within China, which is in fact quite common.[290] Firms whose status as FIE or domestic

[283]Wolff 2011: 81-82.
[284]Wolff 2011: 82.
[285]Wolff 2011: 82-83.
[286]SAT 2012.
[287]Khaw 2015: 1.
[288]Bimler 2007: 131-132.
[289]Wolff 2011: 83.
[290]Wolff 2011: 84.

company was approved before the EITL took effect were allowed a five-year transition period. Hence, the overall implications of the EITL are just now coming to light.[291]

The standard income tax rate is 25 per cent. Reduced tax rates of ten or 20 per cent are available for small-scale enterprises. A reduced rate of 15 per cent applies to companies of the high-technology industry, companies incorporated in certain regions[292] or companies engaged in other business activities encouraged by the government[293].[294]

The CIT regime tries to prevent double taxation and allows Chinese companies to credit foreign CIT paid on foreign sourced income against the Chinese tax but only to the amount due in China.[295] Foreign tax credit (FTC) can be applied annually on CIT on business profit sourced in the foreign jurisdiction and on WHTs for passive income. The FTC is limited. To determine the threshold, the EIT rate of 25 per cent is applied to the amount of taxable income deriving from the respective jurisdiction. If the FTC of a company exceeds the threshold, the FTC can be carried forward for five years. If a DTA applies with a different FTC limit, the DTA overrules the domestic FTC limit.[296]

In addition to the changes stated above, the EITL moreover introduced controlled foreign corporation rules, transfer pricing rules, thin capitalisation rules and general anti-avoidance rules to combat tax avoidance.

Controlled foreign corporation rules try to prevent tax deferral by means of parking income in overseas subsidiaries. The controlled foreign corporation rules are provided in Article 45 of the EITL. A company is considered controlled if a Chinese resident holds at least ten per cent shares with voting rights in the foreign enterprise or if all Chinese residents of the foreign company's shareholders combined own at least 50 per cent of the shares.[297] It features the following scenario: an enterprise is located in a jurisdiction with a tax rate lower than 12.5 per cent, so less than half of Chinas EIT which is 25 per cent, and this enterprise is controlled by a Chinese resident enterprise.[298] If the foreign enterprise refuses to pay out dividends to its Chinese shareholder or reduces said dividends without investing the retained earnings in reasonable business activities, the Chinese company is taxed as if it had received the attributable dividends from the foreign company in the current period.[299]

[291]Vlcek 2014: 541.
[292]Subsidised regions include Qianhai in Shenzhen, Pingtan in Fujian or Hengqin in Guangdong. Encouraged industries in these regions benefit from a reduced EIT of 15 per cent until the end of 2020. (Khaw 2015: 1)
[293] Favoured industries include "agriculture, forestry, animal husbandry and fishery sector, software and integrated circuit industries, major infrastructure projects, vertain environmental projects and certain transfers of technology". (Khaw 2015: 1)
[294]Khaw 2015: 1.
[295]Wolff 2011: 245; Deloitte 2015.
[296]Wolff 2011: 245-246.
[297]Wolff 2011: 96.
[298]Wolff 2011: 95.
[299]Wolff 2011: 96.

To counteract abusive transfer pricing, China has adopted the arm's length principle for transfers between associated parties. An entity is considered a related one if it has at least 25 per cent direct or indirect ownership. Methodologies that are in compliance with the arm's length principle are resale prices, comparable uncontrolled prices or cost plus.[300] If companies defy against the arm's length principle, tax authorities can make "compensatory adjustments"[301] or levy tax up to ten years retroactively.

China has adopted thin capitalisation rules that stipulate a debt-to-equity ratio of 2:1. If a company exceeds this ratio of debt financing, the amount of interest expenses above the threshold cannot be deducted from the tax bill. For financial institutions, a ratio of 5:1 applies.[302]

The general anti-avoidance rules address issues related to PRC companies' holding their overseas investment through SPVs for tax reasons. In general, "SPVs, which are incorporated and listed outside China with their capital and business operations primarily based in China, are often referred to as 'red chip companies' to indicate their inherent connection with China"[303]. The jurisdiction hosting the SPV might help the Chinese resident defer taxes on income from dividends and capital gains.[304]. The general anti-avoidance rules allow SAT to investigate enterprises for tax avoidance or tax evasion strategies. If SPVs do not conduct any substantial commercial activity and are only established to take advantage of PTR or DTA, "the tax authorities may disregard for tax purposes the existence of those enterprises that have no commercial substance, and revoke the tax benefits otherwise secured by the arrangements"[305].[306]

The income of individuals is subject to IIT. China distinguishes between different natures of income, e.g. individual labour, salaries or royalties, and between expatriates and PRC tax residents. "Income from wages and salaries is taxed according to a progressive rate"[307], ranging from three to 45 per cent of monthly taxable income. "Non-employment income, including income from interests or royalties, is taxed at a variable rate ranging from five to 35 per cent depending on the income source.[308] Capital gains, dividends, interests and royalties are taxed at 20 per cent. Expatriates enjoy favourable tax treatment compared to PRC residents. Expatriates living in China for less than five consecutive years pay taxes only on income sourced in China. After five years, the worldwide income is taxed. The current tax

[300]Khaw 2016: 2.
[301]Deloitte 2015: 13.
[302]Khaw 2015: 2.
[303]Qiu 2014: 649.
[304]AmiCorp 2010.
[305]Wolff 2011: 98.
[306]Ibid.
[307]Dezan Shira & Associates 2014.
[308]Dezan Shira & Associates 2014.

credit mechanism allows to set off foreign income tax paid in source countries against PRC IIT liabilities.[309]

As tax haven structures often involve multiple subsidiaries, taxation of passive income is particularly important for the assessment of tax planning strategies. Royalties, dividends, interests and capital gains are all considered gross income and taxed at the CIT rate of 25 per cent. If dividends are distributed from one Chinese resident company to another, they are exempt from taxation.

The WHT on dividends, interests and royalties paid to non-resident companies amounts to ten per cent. Under most DTAs with the PRC these rates are further reduced ranging between five to ten per cent. Interests are also subject to a five per cent business tax and royalties apply for six per cent VAT unless royalties are charged for the transfer of qualified technology.[310]

Until now, China has established a comprehensive tax treaty network with about 100 countries. Among them are some important tax havens like HK, Mauritius, Singapore or Luxembourg and the Netherlands. As already explained in chapter two, double treaty agreements have the purpose to reduce WHT rates and prevent double taxation. China's treaties are mostly based on the OECD model treaty.[311] The benefits deriving from that contract are only granted to tax payers who are residents in one of the contracting states of the treaty. "Most of the DTAs stipulate that only the 'beneficial owner' who is a resident of the other treaty state can enjoy treaty relief in respect of dividends, interest, royalty and capital gains"[312]. While the term resident is straight-forward, it is often left unclear what constitutes a beneficial ownership. To clarify on the definition of a beneficial ownership, the tax authorities resort to domestic tax provisions.[313]

Concerning FTC, China's DTAs follow the credit method provisions of Art. 23B of the OECD model treaty which states that the amount of income tax paid in a foreign jurisdiction can be credited against the tax amount due in China. This is so far in line with China's domestic provisions. The DTA deviates in its stipulation that when a company is exempted from WHT but the DTA provides that the amount of exempted tax is deemed to have been paid, the State may nevertheless take the exempted income or capital into account when calculating the amount of tax on the remaining income or capital of said resident.[314]

[309]Wolff 2011: 85.
[310]Khaw 2016: 1-2.
[311]Deloitte 2015: 12-13.
[312]Wolff 2011: 244.
[313]Ibid.
[314]Wolff 2011: 246; OECD 2014: 37.

3.4.2. Hong Kong

For many years now, Hong Kong (HK) has been considered a gateway to China. This is due to HK's geographical and cultural adjacencies to the Mainland and its role as a developed OFC and tax haven. Being a former British colony, HK has developed linkages to other British territories like the CI and BVI. HK thus offers access to deep pools of capital.[315] The linkages to other tax havens can be traced back to 1982, when it was announced that HK would return to China in 1997. HK companies were afraid of China's weak institutional environment and property rights. To protect their property from expropriation and nationalisation, HK firms chose to relocate corporate registration domicile to jurisdictions with similar legal systems and strong property rights. It is reported that by mid-1993, 60 per cent of all HK listed firms had relocated their corporate registration. Former British offshore colonies, like Bermuda and the CI were the number one go to address for this undertaking.[316] Apart from the prevalent English common law, which provided the former HK companies with "consistency and continuity"[317], the Caribbean registration offered better access to international markets and reduced tax obligations in HK.[318] HK responded to this development by allowing foreign-registered firms to list on the Hang Seng stock exchange. This way, HK could retain many of the businesses that incorporated offshore.

Even though HK was handed over to China in 1997, it is designated a Special Administrative Region within China in line with the one country, two systems policy. According to Article 108 of the Basic Law[319], HK can "practise an independent taxation system", "enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation"[320].

After its return to China, HK chose to continue its low tax strategy. HK applies a territorial tax system which means that profits and income that arise in or derive from HK itself are taxed. Offshore income is exempt from taxation. Companies are presented with some leeway when defining if profits are on- or offshore income. When e.g. HK companies negotiate business contracts such that relevant operations[321] are conducted outside HK, the income obtained from this business arrangement is considered offshore profit. Additionally, if a

[315]Sutherland 2010: 17.
[316]Sutherland 2010: 17; Vlcek 2010: 120.
[317]Vlcek 2014: 539.
[318]Ibid.
[319]The HK Basic law is an elementary form of constitution of HK. The law was enacted by the National People's Congress of China in April 1990 in preparation for HK's handover back to China in 1997. In accordance with the "One country, two Systems" concept, the Basic law protects HK's position as a special administrative region and allows the continuance of the common law and market economy. (Wolff 2011: 369)
[320]HK SAR 1990: 35.
[321]"Merely auxiliary activities, such as accounting or the organisation of cash flows in HK, are permitted." (Eicke 2009: 173.

service business provides services in and outside HK, profits from the domestic business can be attributed to the offshore activities.[322]

HK applies a low CIT at a rate of 16.5 per cent and taxes individual income with only 15 per cent. There are no taxes on dividend income and capital gains. WHT are only levied on royalties, but the tax rate is kept low. Dividends and interest payments are exempted from WHT.

There are some downsides to HK's tax system because of its tax haven function. E.g. other countries target HK holding companies with controlled foreign corporation requirements and ask for proof for activities and substantial operations.[323] Moreover, interest deductions from a company's tax bill are limited and group relief is not granted. HK has only few tax treaties so far. Nevertheless, foreign companies increasingly establish investment conduits in HK, especially because of its very lucrative DTA with China.

The China-HK DTA was adopted in 2006 and offers low WHT rates on passive income that are unmatched by any other of China's DTA's. Without the treaty ten per cent WHT on dividends are due in China. Under the DTA, HK companies that hold at least 25 per cent of the capital of a Chinese subsidiary are subject to a reduced WHT of five per cent on the dividends paid by the Chinese company to the HK investors. This means dividends paid to other tax havens like the Caribbean Islands are subject to a reduced rate of WHT if they are channelled through HK. This cost advantage would disappear if the dividends were paid directly from China to the BVI and the CI, because these two countries have no tax arrangement with China.[324]

The WHT on interest payments and royalties is reduced to seven per cent. Government institutions are exempted from WHT on interest payments. If a HK investor alienates its equity interest in a Chinese company, the capital gains deriving from it are not taxed unless the assets of the Chinese company comprise immovable properties situated in China. In that case ten per cent WHT on capital gains apply.

The China-HK DTA and HK's legal system that international investors are familiar with and trust, give HK a competitive advantage. Foreign as well as Chinese companies include HK in their tax strategy when planning their investment flows in and out of China. This is why SPVs with PRC investment, are most commonly adopted in HK.

Yet since 2009, Chinese tax authorities have decided that HK SPVs must have a HK tax residency certificate and evidence of substantial business activity in HK. Substantial business activity includes e.g. directors with a permanent residency in HK or reasonable office and

[322]Eicke 2009: 173; PwC 2011.
[323]Eicke 2009: 175.
[324]Qiu 2014: 651.

employee costs. Trust companies come up with ways to help their clients circumvent these new restrictions. As an example, Amicorp, a global fiduciary service provider, offers its services to help foreign companies add fake substance to their HK SPVs. It offers for instance to arrange shareholder meetings and signatures on contracts. It helps with applications for tax residency certificates or registration of intangible assets like patents and trademarks.[325]

Even though HK is a very established OFC and tax haven, especially because of its strong bounds to China, Eicke expects HK to enhance its attractiveness for international holding structures even more in the future as HK finds itself in fierce competition with Singapore.[326]

3.4.3. The British Virgin Islands

The British Virgin Islands (BVI) consist of 60 islands, only a fifth of which are inhabited.[327] Until the early 1980s, the BVI attracted international businesses mainly with low income and profit taxes. In 1984, the BVI changed their strategy and offered IBCs as a tax-free business form for offshore banks, investment and holding companies and affluent individuals.

The China Leaks from 2014 have revealed that the BVI, next to HK, are the most popular tax haven for Chinese holding companies. Overall 22,000 clients were identified with addresses on the mainland or in HK, many of which with offshore accounts in the BVI. Even though not all money held offshore is necessarily associated with corruption or illicit activities, the sheer amount of well-connected Chinese people identified, does suggest otherwise.

Among the identified Chinese residents were so-called princelings, a term referring to relatives of China's political elite. Among those princelings are the brother-in-law of current president Xi Jinping, Deng Jiagui, the son of former Premier Wen Jiabao, Wen Yunsong and daughter of former Premier Li Peng, Li Xiaolin.[328] However, the revelations of the China Leaks might not only shed a bad light on the Chinese government. An article in The Guardian anticipates that the UK will suffer political embarrassment as well, as "UK authorities retain a degree of responsibility and connection with the Islands"[329] and current Prime Minister Cameron has "publicly pledged to take action against offshore secrecy and offshore tax avoidance, including crown protectorates"[330].

Even though since 2013, the BVI have to follow stricter rules and must reveal bank clients and offshore company holders to the UK, Germany, France, Italy and Spain, serious consequences fail to materialise considering that the business registers simply disclose names of stooges and sham companies.[331] In 2013, the number of active registered companies in the

[325] Amicorps 2010b: 1-3.
[326] Eicke 2009: 175.
[327] Merten 2014: 206.
[328] Walker Guevara et al. 2014.
[329] Ball 2014.
[330] Ibid.
[331] Merten 2014; 390-391.

BVI increased to 544,440. In this respect, active means that "all fees are paid and the registration is current, and not that the firm is actively engaged in any current business transaction or relationship"[332].

Another particularity of the BVI is the Virgin Islands Shipping Registry (VISR) allowing international ships to register with the BVI and carry the British flag. As a popular target country for the above explained strategy called flags of convenience, the BVI have developed into one of the biggest yacht charter centres in the Caribbean.[333]

BVI taxation does not apply a residency concept, it treats all companies incorporated in the country as residents and potential subjects to income taxation. All local business companies fall under the BVI Business Companies Act 2004 which exempts them from taxes on active and passive income, including capital gains deriving from shares or debt obligations.[334] In addition to that the BVI have adopted a zero-rated income tax regime for all corporate entities domiciled in the BVI since 2005. "There are no death duties, inheritance taxes or gift taxes"[335] and no VAT or sales tax is levied either.[336] The only WHT derives from the European Savings Directive applicable since 2005 levied on interest payments to natural persons with residency in the EU at a rate of 20 per cent[337]. The WHT can be avoided if the depositor exchanges full information about the beneficial owner in the EU and the payment with the relevant member state's tax authorities.[338] The BVI compensate some of the tax income with registration fees and annual costs. For an IBC, the costs amount to US$350 respectively if the issued capital does not exceed US$50,000, otherwise fees amount to US$1,100 respectively.[339]

The BVI have not implemented any anti-avoidance rules and officially has only two DTAs with Switzerland and Japan. Both treaties were originally negotiated by the UK and afterwards extended to the BVI. Although they are technically still in force, they are not used in practice. The country's priority lies on Tax Information Exchange Agreements (TIEA). To date, the BVI have entered into such Exchange Agreements with more than 20 different countries, including China.

With the Payroll Tax Act from 2004, the IIT was reduced to zero. Employer with a business undertaken in the BVI have to pay payroll tax on their employees' wages, including employees whose wage is not paid in the BVI.[340] The employer pays two to six per cent of

[332]Vlcek 2014: 539.
[333]Merten 2014: 394.
[334]PKF 2013: 1.
[335]PKF 2013: 2.
[336]PKF 2013: 2; Romney 2016.
[337]From 2005 to 2008 the rate was 15 per cent, after 2008 it increased to 20 per cent. (PKF 2013: 2)
[338]PKF 2013: 2; Romney 2016.
[339]Merten 2014: 391.
[340]PKF 2013: 3.

gross salary paid and the employee eight per cent.[341] Income taxation for taxpayers without residency in the BVI is only levied on income sourced or received in the BVI at a rate of three to 20 per cent.[342] The law also applies to partners in a partnership if they offer services to the partnership or contribute to the income of the company.

Even though Chinese companies are more frequently connected to the BVI than the CI, Chinese companies listed on the HKSE seem to prefer to incorporate in the CI. The reason for this is that, until 2009, companies incorporated in the BVI were not allowed to list on the HKSE. This changed. Today, BVI companies can issue IPOs in HK and the US, which eliminates the CI's former competitive advantage.[343]

Since then equity investment to China through an incorporated BVI holding listed on the HKSE is expected to increase. If a business already owns holding entities in the BVI, restructuring processes before the listing process of the BVI entity are simplified. Considering that the BVI are already bustling with holding entities of Chinese residents, this further supports the expectation that incorporations in the BVI will increase in the upcoming years.

In addition to that, in 2009 the BVI signed a Tax Information Exchange Agreement with China. This improves the BVI' profile and competitiveness and may attract more companies that might have chosen HK over the BVI before, to not hamper with their business image.[344]

In comparison to HK, the BVI are very flexible when it comes to future tax planning and exit strategies. Offshore companies in the BVI can migrate to another jurisdiction without re-incorporation or transfer of assets and liabilities, and can also merge with other corporate entities from any jurisdiction. This is not possible for HK registered companies. While those in the BVI can also repurchase shares more easily using money made from profits, a HK company can only repurchase shares with money from distributable profits or capital if it is a private company. Before shares can be repurchased many requirements have to be fulfilled. Approval from creditors and statements from all directors must be obtained beforehand.[345]

3.4.4. The Cayman Islands

The Cayman Islands (CI) consist of three Islands. The most important economic pillars are the financial and the tourism sector. The CI follow a nil-taxation regime since the 17th century, which means that there are no taxes at all. Despite its classical tax haven nature, the CI developed its financial centre late compared to other Caribbean offshore centres. It was not until political unrests in the Bahamas occurred in the early 1970s that major banks took notice of the CI, relocated from the Bahamas to the CI and expanded their presence there. Today

[341]Romney 2016.
[342]Merten 2014: 393.
[343]Woo et al. 2009: 1-2.
[344]Greguras/ Liu 2003: 1-2; Woo/ Lee/ Burns 2009: 1-2.
[345]Mitchell et al. 2012.

around 230 international banks, 11,000 hedge funds and 10,000 offshore companies are domiciled in the CI.[346]

There are some fees that the CI government levies to collect at least some revenue for economic development from foreign investors. Among those fees are stamp duties, customs duties and business license fees. The formation of a company costs between US$850 and US$2,400 depending on the amount of share or corporate capital. In addition to that, companies have to expect annual fees of 0.05 per cent on current capital and 0.05 per cent on augmented capital as well as running charges starting at US$425.[347] Banks and trusts need official authorisation from the CI government to legitimise their business. When applying for the authorisation, the owner of the bank or trust has to invest a minimum capital of US$500,000.[348]

The CI are mostly autonomous but not completely independent from the UK. Nevertheless, its adjacent location to the US explains why the US is the most important trading partner. These ties are also the source why the CI was heavily pressured from the OECD to abandon its bank confidentiality. The CI agreed to reveal the true identity of bank account holder and offshore company owners to the UK, Germany, France, Italy and Spain.

However, these stricter regulations for the financial market have not harmed the CI's popularity as a haven for money laundry so far. 40 per cent of the world's biggest banks and 40 per cent of the world's hedge funds have offshore subsidiaries in the CI due to low governmental regulations, zero taxation regime, free movement of capital and the well-established financial and legal structure. The laws governing offshore trusts allow international customers to circumvent the often stricter inheritance tax laws.[349]

The CI are also a popular jurisdiction for companies with business activities in China. One of their major advantages is that companies incorporated in the CI can conduct IPOs in HK and the US. This is also the reason why many Chinese technology and internet companies list on the US stock exchange and are involved in variable interest entity structures (VIE), explained in chapter 3.5.2., to allow foreign companies entrance into restricted industries in China. Until 2009, only companies in Bermuda, the CI, China and HK were allowed to list on the HK stock exchange. The BVI were added to that list in 2009.[350] This might explain why the CI before 2009 were a popular tax haven for incorporation of companies with business in China. The CI was also often favoured over incorporation in Bermuda as they offered the following advantages: in the CI, a company could and still can be established in less than a day compared to a couple of weeks in Bermuda. Additionally, in comparison to Bermuda,

[346]Merten 2014: 395-397; Fantasia 2016.
[347]Merten 2013: 397.
[348]Ibid.
[349]Ibid.
[350]Woo et al. 2009: 1.

amending charter documents takes less time in the CI and legal fees as well as start-up and annual government fees are lower compared.[351]

Furthermore, an offshore structure including the CI "reduces the impact of China's currency exchange restrictions"[352]. In China, every movement of funds, including FDI in a Chinese entity as well as cash transfer out of China, requires government approval first. The simplest CI offshore structure contains a CI company with a Chinese subsidiary. This structure allows that investments aimed at the Chinese subsidiary are made to the CI entity, which funds the Chinese subsidiary on a regular basis and thus keeps investment activities mostly outside China. It is also possible to have international customers pay the CI directly for services or products instead of the Chinese subsidiaries and avoid Chinese regulations this way.[353]

Even though the CI do not have DTA's, they can take advantage of the HK-China DTA by interposing a HK holding entity as a subsidiary of the CI parent company and as the parent of the Chinese subsidiary. This aspect can also help to explain why when it comes to FDI, HK, China and the CI are highly connected.[354]

Just like the BVI, the CI outperforms HK's attractiveness as a tax haven in various respects. Similar as stated for the BVI, the CI's flexibility with respect to future tax planning and exit strategies as well as merging and migrating possibilities into other jurisdictions and easier share repurchase options should be mentioned here.[355]

3.5. Chinese tax haven strategies

After having seen the tax schemes of China's most frequently used tax havens, the following part examines how these regimes are used for tax avoidance in more detail. Common strategies include round-tripping, the implementation of variable interest entities and onward-journeying. First, the concept of the respective strategy is explained and afterwards assessed from a tax perspective.

3.5.1. Round-tripping

Chinese domestic companies apply a strategy called round-tripping. Attempts to estimate the share of round-trip capital in China's FDI flows led to results ranging from 10 to 66 per cent.[356] It is very difficult to identify which flows represent round-tripping, as the investment flows are very complex. Nevertheless, there is a significant amount of round-tripping going on making it worthwhile to take a closer look at this strategy.

[351]Greguras et al. 2008: 1-2.
[352]Greguras et al. 2008: 1.
[353]Greguras et al. 2008: 3.
[354]Ibid.
[355]Mitchell et al. 2012.
[356]Vlcek 2010: 121.

The official definition of round-tripping in China can be found in Circular 37[357], which regulates the round-trip activities since 2014. According to the new and more comprehensive definition, round-trip investment refers to "direct domestic investment activities conducted by domestic residents directly or indirectly through SPVs, by virtue of setting up new foreign-invested enterprises or projects in China, mergers and acquisitions, and obtaining ownership, controlling rights or management rights in the enterprises or projects"[358]. Basically, round-tripping entails that a Chinese company sets up a SPV, often in the form of an IBC[359], abroad, preferably in HK or in the Caribbean, only to reinvest via this SPV in a company in Mainland China. The SPV is equipped with enough capital to acquire shares of a Chinese operating company on the Mainland. This has two financial advantages for the overall corporation. Firstly, the acquired company on the Mainland is deemed a foreign invested enterprise (FIE) and until 2008 was eligible to favourable taxation compared to domestic companies. Secondly, the SPV is prepared to list overseas. When Chinese companies seek international financing, it has proven important for them to adopt an offshore holding structure in a common-law jurisdiction[360] like HK or other former British colonies in the Caribbean. International investors are more familiar and comfortable with the corporate governance and shareholding agreements of countries applying common law and hence more inclined to invest.[361]

In the last couple of years, the Chinese government has started to gradually terminate the abuse of the legal loopholes for round-tripping. The State Administration for Foreign Exchange (SAFE) promulgated Circulars 11[362] and 29[363] in 2005. Both Circulars became "household names in foreign investment circles"[364]. The Circulars required on the one hand that Chinese residents disclosed any indirect ownership interests in FIEs to SAFE and on the other hand made it obligatory for Chinese as well as foreigners to seek SAFE approval if they

[357]国家外汇管理局关于境内居民通过特殊目的公司境外投融资及返程投资外汇管理有关问题的通知 [Notice of the State Administration of Foreign Exchange on Relevant Issues Concerning Foreign Exchange Administration for Overseas Investment, Financing and Round Trip Investment Undertaken by Domestic Residents via Special Purpose Vehicles] (SAFE 2014; Sui/ Wang 2014).
[358]Siu/ Wang 2014.
[359]Vlcek 2010: 120.
[360] Common Law and civil law are two major legal traditions adopted in most countries. Common law emerged in England and was spread to the British colonies and other countries influenced by Anglo-Saxon traditions, like the U.S. or Canada. Common Law is mostly based on precedent instead of legal codes. The civil law is the legal system prevalent in Continental Europe. It is highly codified with comprehensive legal codes that try to capture all eventualities brought before a court. Common law is hence much more flexible than civil law. While HK as a former British colony adopted common law, China was influenced by Continental Europe, especially Germans civil law system. (The Robbins Collection 2010: 1;5).
[361]Chao/ Xu 2008: 1.
[362]国家外汇管理局关于完善外资并购外汇管理有关问题的通知 [Circular on Issues Relating to improving the Administration of Foreign Exchange in Mergers and Acquisition by Foreign Investors] (Hogan and Hartson L.L.P. 2006: 1).
[363]国家外汇管理局关于境内居民个人境外投资登记及外资并购外汇登记有关问题的通知 [Circular on Issues Relating to Registration by Domestic Individual Residents of Offshore Investment and the Foreign Exchange Registration of Mergers and Acquisition Involving Foreign Investors] (Hogan and Hartson L.L.P. 2006: 1).
[364]Hogan and Hartson L.L.P. 2006: 2.

wished to hold equity interests in an offshore entity or wanted to establish a domestic operating subsidiary of such entity.[365] As this approval has hardly ever been granted, private enterprises in China have a hard time raising funds for their business activities. Thus, private equity and especially venture capital investments into China declined dramatically in recent years. This might explain why the overall FDI into China nearly stagnated from 2005 to 2006, as shown in table 2. What this development definitely revealed, was that a large proportion of FDI into China consisted of round-trip investment, hence indicated the importance of round-tripping for China.[366] Circulars 11 and 29 were very quickly replaced by a more liberal Circular 75[367], after their dramatic effect on China's FDI became visible.

Table 2: Inbound FDI into the PRC from the world, HK, the BVI and the CI, 2003 to 2012 [Billions of Dollars]

Investor	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
World	53,5	60,6	72,4	72,7	83,5	108,3	94,0	114,7	124,0	111,7
HK	17,7 (33%)	19,0 (31%)	17,9 (25%)	21,3 (29%)	27,7 (33%)	41,0 (38%)	46,1 (49%)	60,6 (53%)	70,5 (57%)	65,6 (59%)
BVI	5,8 (11%)	6,7 (11%)	9,0 (12%)	11,2 (15%)	16,6 (20%)	16,0 (15%)	11,3 (12%)	10,5 (9%)	9,7 (8%)	7,8 (7%)
CI	0,9 (2%)	2,0 (3%)	2,0 (3%)	2,1 (3%)	2,6 (3%)	3,2 (3%)	2,6 (3%)	2,5 (2%)	2,2 (2%)	2,0 (2%)

Source: UNCTAD 2014a; UNCTAD 2015: A2.

Even though the favourable tax treatment for FIE was abolished after 2008, the round-trip scheme has not lost its appeal. It is assumed that instead of directly investing from the BVI and the CI back to Mainland China, the money is increasingly routed via HK. Aspects supporting this assumption are on the one hand that, after the EITL, the China-HK DTA offers the most favourable tax rates for investment into China. It seems likely that Chinese residents take advantage of that. On the other hand, there has been a significant increase in investment volumes from HK to China in absolute as well as in relative terms supporting the theory that money from the Caribbean is increasingly channelled back into China via HK. The FDI flows to China depicted in table 2 show that after 2008, investment flows from the Caribbean Islands to China declined continuously. This development cannot be explained with decreasing global economic activity during the European financial crisis, as during that time China's overall FDI and OFDI increased immensely.

[365]Wolff 2011: 22.
[366]Hogan and Hartson L.L.P. 2006: 2.
[367]国家外汇管理局关于境内居民通过境外特殊目的公司融资及返程投资外汇管理有关问题的通知 [Notice on Relevant Issues Concerning the Administration of Foreign Exchange from Domestic Residents' Financing Through Overseas Special Purpose Vehicles and for Round-trip Investments] (SAFE 2005; Wolff 2011: 22).

Table 3: Inbound FDI from the PRC, BVI and the CI to HK, 2007 to 2012 [Billions of Dollars]

Investor	2007	2008	2009	2010	2011	2012
World	64,2	48,4	59,2	86,3	96,3	83,4
BVI	15,0 (23%)	18,2 (38%)	28,0 (47%)	28,3 (33%)	31,5 (33%)	35,5 (43%)
CI	3,0 (5%)	0,6 (1%)	2,5 (4%)	-1,8* (-)	6,0 (6%)	-2,1* (-)
PRC	35,6 (56%)	25,7 (53%)	26,0 (44%)	37,3 (43%)	50,5 (52%)	38,2 (46%)

Source: UNCTAD 2014b; UNCTAD 2015: A2.
* "FDI flows with a negative sign indicate that at least one of the three components of FDI (equity capital, reinvested earnings or intra-company loans) is negative and not offset by positive amounts of the remaining components. These are instances of reverse investment or disinvestment." (UNCTAD 2013)

A closer look at inbound FDI to HK (Table 3) also supports this trend. Especially money streams to HK originating in the BVI, which are known to host a high amount of Chinese holding companies, have surged. The BVI' OFDI to HK in relation to their overall OFDI reached an all-time high in 2009, which could mirror an immediate reaction to the EITL.

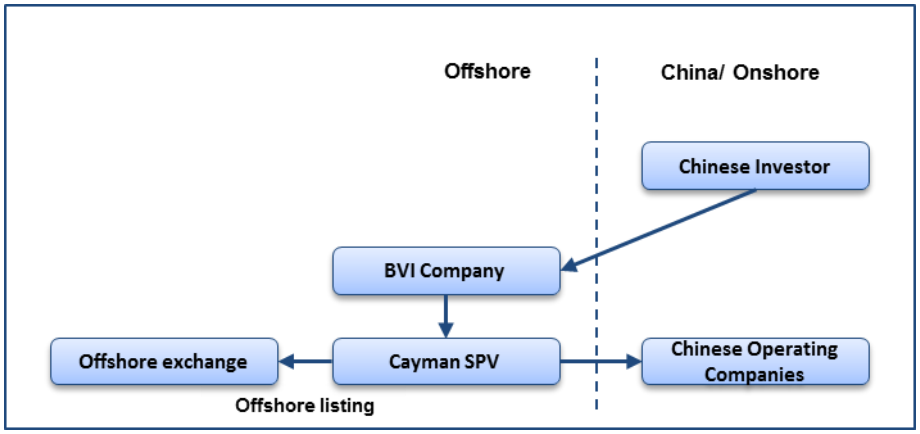
Circular 75[368] ruled the foreign exchange administration for Chinese round-trip investment for nearly a decade, before it was repealed by Circular 37 in 2014. Circular 37 is still in place. One of the most significant changes the transition to Circular 37 introduced, affects the registration of SPVs. Prior to Circular 37, domestic residents had to register all SPVs they owned or controlled. Pursuant to Circular 37, only the first level of SPVs has to be registered. Considering the often complex and multi-layered structures of offshore SPVs in multiple tax havens including the BVI, the CI and HK, this is an immense simplification and encouragement. In general, Circular 37 loosens governmental control over foreign exchange and increases the flexibility of foreign investments.[369]

After examining developments of round-trip regulations and investment streams to China's most frequently used tax havens, the next section now illustrates a typical round-trip structure and analyses it for tax purposes. The Enterprise Income Tax Law (EITL) was passed on March 16, 2007 and took effect on January 1, 2008. As already explained above, it consolidated China's two track tax system which originally favoured FIEs and discriminated against domestic companies.[370] Exceptions included foreign investments in environment,

[368]国家外汇管理局关于境内居民通过境外特殊目的公司融资及返程投资外汇管理有关问题的通知 [Notice on Relevant Issues Concerning the Administration of Foreign Exchange from Domestic Residents' Financing Through Overseas Special Purpose Vehicles and for Round-trip Investments] (SAFE 2005; Wolff 2011: 22).
[369]Siu/ Wang 2014.
[370]SAT 2007.

public infrastructure and technology transfer.[371] Major changes included a WHT of ten percent on dividends paid from China to foreign investors.

Figure 1: Example of round-trip structure with red-chip listing



Source: Wolff 2006: 57-58; AmiCorp 2010a: 1.

Since the EITL has taken effect, Chinese companies face double or triple taxation. The Chinese operating company, in figure 1 represented by the FIE, must pay 25 per cent income tax on its profits. The after-tax profits are distributed as dividends to the red-chip company, represented by the Cayman SPV. If the red-chip company is considered a non-resident, the dividends are taxed with ten per cent WHT. A third tax liability could arise once the profits are repatriated to China. Domestic shareholder companies, like the Chinese investor in figure 1, are liable for again 25 per cent income tax. Tax credits can reduce the tax bill directly, but only taxes paid by the first three tiers of foreign subsidiaries are allowed as tax credits.[372] If the red-chip company is however recognised as a Chinese-controlled enterprise incorporated overseas (CCEIO) and therefore a Chinese resident liable to Chinese taxation, the dividends received from the Chinese operating company would be exempted from taxation.

Between 2009 and 2013, 23 larger group corporations were identified as Chinese residents and had to migrate back into China. Among those companies were large SOEs like China Unicom, China Mobile or China National Offshore Oil Cooperation. After the implementation of the EITL, some red-chip companies found the benefits of being a tax resident in China to outweigh the costs, and thus applied voluntarily for a "Chinese resident" status. Many red-chip companies, however, are not eager to become a Chinese resident for tax purposes. In particular, as the Chinese resident status also implies that taxes have to be withheld from dividends paid by the CCEIO to non-Chinese entities, which disadvantages certain business structures.[373]

[371] Vlcek 2014: 535.
[372] Qiu 2014: 652.
[373] Qiu 2014: 653.

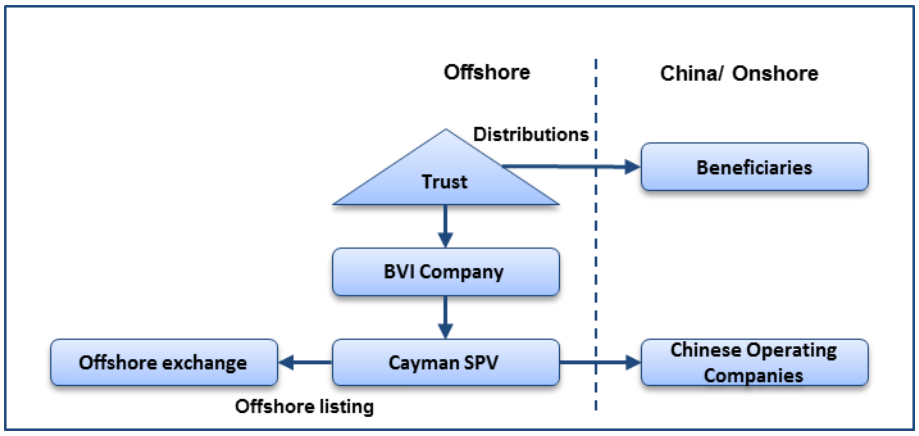
Tax consultancies came up with strategies to avoid the CCEIO designation. Different strategies for keeping a foreign status were presented in the Amicorp news flash from 2010.

One strategy proposes to transfer effective control and management of the BVI Company in figure 1 outside of China by

- "Appointing more than ½ non-Chinese-resident directors,
- Holding shareholder meetings and director meetings outside China,
- Executing shareholder or director resolutions outside China and
- Making decisions on management and major operations outside China."[374]

Another strategy embraces offshore trusts and is illustrated in figure 2.

Figure 2: Example of a trust structure



Source: Amicorp 2010a: 2.

The second strategy entails that the Chinese resident transfers its assets to a foreign trustee and turns itself into a beneficiary of the trust. In figure 2, the trustee takes over the shares of the BVI Company from the Chinese resident and is hence the legal owner who manages the assets and distributes them to the beneficiaries. As long as the trustees and the holding companies that hold the trust property are non-Chinese or incorporated outside of China, have no permanent establishment in China nor derive passive income from China as well as locate effective management and control overseas, the foreign trust, including the BVI Company, should not be considered a taxable entity in China. This trust structure can protect the assets from political or economic uncertainty or in the case of lawsuits and offers little administrative and tax burdens once the assets are transferred to the beneficiaries.[375] According to Amicorp, the taxes that most likely will be levied, are IIT when distributions are made to individual beneficiaries in China.

[374] Amicorp 2010a: 2.
[375] Amicorp 2010a: 2.

After this comprehensive examination of China's round-tripping behaviour involving its most frequently used tax havens, it can be argued that even though the Chinese government tries to increase its oversight over round-trip investment, it relaxes foreign investment regulations probably because it is aware of the importance round-trip investment poses for the Chinese economy. Moreover, it seems that attempts to eliminate round-tripping might be fruitless. When the former incentive for round-tripping was abolished, the round-trip scheme did not lose its appeal because Chinese investors adopted to the circumstances. The purpose of the strategy shifted from tax advantages to capital acquisitions and investment was increasingly channelled via HK to take advantage of the China-HK DTA. Round-tripping therefore will continue to play a major role in China's tax haven strategies.

3.5.2. Variable interest entity

This part outlines the concept of variable interest entity (VIE) structures and discusses the multiple risks associate with it. Furthermore, governmental regulations that affect the VIE structure are analysed. Specifically, the new foreign investment law and its implication for the VIEs future are assessed. This part refrains from analysing tax liabilities of VIE structures as they serve the sole purpose to circumvent China's market restrictions. Furthermore, different VIE structures were already assessed for tax liability in a study by Tyrell and identified as tax-inefficient.[376]

When it comes to FDI, the Chinese government classifies industries into four categories, namely industries for which FDI is encouraged, permitted, restricted and prohibited. Investment in encouraged industries is promoted and subsidised with benefits like tax incentives or simplified approval procedures. Foreign investment in restricted industries faces foreign shareholder ratios or limited investment forms for entry like joint-ventures in the automobile sector. In prohibited industries, no foreign investment is allowed. Industries not listed, are deemed permitted. VIEs are companies that work in industries blocked for foreign investment, which include e.g. the communication and internet industry[377], that nevertheless want to raise money on foreign stock exchanges.[378] The VIEs own restricted licences issued by the Chinese government and implement VIE structures to circumvent major restrictions by ensuring total Chinese ownership while giving foreign investors access to licences. This can be accomplished through the variable interest which refers to the fact that a Chinese domestic company is controlled by foreign investors not through equity but through a complicated arrangement of contracts.[379] This is better captured in the Chinese term for VIE which is 协议

[376]Dienst 2012: 52-60.
[377]A detailed list of industries and their categories is published by MOFCOM and NDRC in China's Catalogue for the Guidance of Foreign Investment [外商投资产业指导目录]. It is regularly amended. The most recent version took effect on 10.04.2015. (MOFCOM 2015)
[378]Yao 2015.
[379]Schiavenza 2014.

控制 (xiéyì kòngzhì) and means control exercised through agreements. The typical structure is of a VIE illustrated in figure 3.

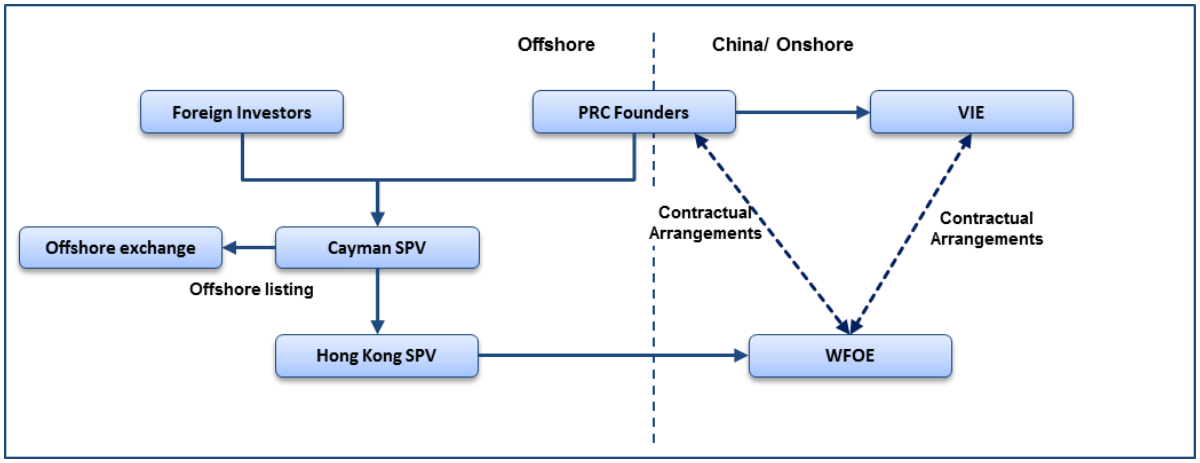
Foreign investors together with Chinese residents establish an offshore company. This offshore vehicle sets up a company in HK. The next step is what differentiates the VIE structure from red-chip companies. Instead of acquiring equity interest in the domestic operating company, referred to as VIE in figure 3, directly, the HK SPV establishes a wholly foreign owned enterprise (WFOE) in China. Due to restrictions on foreign investment, the WFOE cannot obtain licenses or approvals for the business itself. To operate in the desired industry, the WFOE accesses required permits through the VIE company which owns the necessary assets. These assets "cannot be legally owned by or transferred to the WFOE under PRC foreign investment restrictions"[380], which is why the WFOE must establish effective control over the domestic VIE through contractual arrangements.

These arrangements can roughly be divided into those that provide effective control over the VIE and those that enable the transfer of economic benefits of the VIE to the WFOE.[381] Some examples of these contractual arrangements are e.g.

- *Call Option Agreement:* Under this financial contract the shareholders of the VIE allow the WFOE to call in, meaning buy, partly or completely the equity interest in the VIE at the lowest price possible under PRC law.
- *Loan Agreement:* The WFOE extends a loan to the shareholders of the VIE to fund the domestic company.
- *Voting Rights Agreement:* The VIE shareholders entitle the WFOE's designee to exercise all of their equity interest rights which include voting, inspection and information, signing as well as election rights among others.
- *Exclusive Service Agreement:* The WFOE provides services, typically consulting or technical services, to the VIE with the purpose of shifting the VIE's profits to the WFOE.
- *Asset Licensing Agreement:* The WFOE licenses certain assets, typically including intellectual property, in exchange for royalties, to the VIE.

[380]Roberts/ Hall 2011.
[381]Ibid.

Figure 3: Example of a typical VIE structure



Source: Roberts/ Hall 2011; Zeng/ Bai 2012.

The structure allows for the following cash flows. The Cayman SPV can fund the HK SPV with capital obtained from its listing. The HK SPV funds the WFOE. The WFOE extends a loan to the PRC individuals, who in return can use the money to establish and/ or fund the domestic operating company. Once the domestic company generates profits, they are distributed as dividends to the PRC founders. The dividends serve as interest and loan repayments to the WFOE. Contractual arrangements, e.g. the Exclusive Service Agreement, between the VIE and the WFOE induce a money stream from the VIE to the WFOE for provided services. The WFOE will distribute the loan and service repayments as dividends to the HK SPV, which passes the money on as dividends to the Cayman SPV.[382]

The VIE structure was created in 2000 by Sina, which is why this captive structure is also commonly referred to as the sina-model. Sina, an internet company, wanted to circumvent the regulatory restrictions on foreign investment in internet-related business in China. Even though the VIE structure was not officially sanctioned, Sina received unofficial support from the Ministry of Industry and Information Technology (MIIT) for its IPO and listing in the US.[383]

From 2001 to 2006, the VIE structure was mainly used "by companies in new technology or emerging industries where private companies predominated"[384]. Among the first movers where internet companies, like Tencent, Baidu and Tudou, private education companies, like New Oriental, or media companies like Focus Media and Vision China Meida.[385] When regulatory backlashes by the PRC failed to materialise, the captive structure grew in popularity.[386]

[382]Zeng/ Bai 2012.
[383]Back in 2000, the Ministry was called Ministry of Information Industry (MII). (Roberts/ Hall 2011)
[384]Roberts/ Hall 2011.
[385]Zeng/ Bai 2012.
[386]Roberts/ Hall 2011.

Another influence promoting the expansion of the captive structure was exerted by the enactment of Circular 10[387] in 2006. Circular 10, also known as the "M&A Rules", established that "where a domestic natural person intends to take over his/her related domestic company using an offshore company which he/she established or controls, the takeover is subject to MOFCOM approval"[388]. "Where a domestic natural person holds equity interests in a domestic company through an offshore [SPV], any transaction involving the overseas listing of that SPV is subject to the approval of the China Securities Regulatory Commission (CSRC)"[389]. As the Circular does not apply to VIEs, because VIEs do not involve an acquisition of a domestic company nor direct equity transfer, many companies chose to avoid the approval requirements by adopting the VIE structure.

While originally the captive structure was mostly implemented by asset-light industries,[390] it has also been increasingly adopted by asset-heavy companies.[391] However, asset-heavy industries, e.g. coal trading, seed production or auto retailing, are often dominated by SOEs and thus put the VIE structures on the radar of the PRC government. According to Roberts and Hall this "has apparently been a significant factor in the recent increase in PRC regulatory scrutiny of VIE structure"[392].

The VIE has been widely discussed in the context of Alibaba's IPO on the New York Stock Exchange (NYSE). Like 95 of the 200 Chinese companies listed on the NYSE and Nasdaq in 2014, Alibaba employs VIEs. The VIE is in this case Alibaba's Chinese company who owns the strategical Chinese assets and is owned by Alibaba's executive chairman Jack Ma and co-founder Simon Xie. The company owns the licenses to conduct business in the internet technology sector in China. However, as foreign investment in this industry is prohibited, the company must stay wholly Chinese owned. Foreign shareholders therefore do not purchase ownership rights of the VIE company but of a separate offshore company, Alibaba Group Holding Limited, listed in the CI. The offshore company has rights to Alibaba China's profits through contracts.[393]

Even though VIEs have grown in popularity over the last 15 years, there are many inherent and external risks. If the contractual arrangements are insufficient, the control over the VIE can get lost. A high-profile example of loss of control over a VIE involves the online payment service Alipay. Alipay functioned as a VIE for Alibaba Group. When the PBOC denied Alipay a license for third-party payment services because of its foreign controlled status, Jack

[387]关于外国投资者并购境内企业的规定 [Provisions on the Takeover of Domestic Enterprises by Foreign Investors] (MOFCOM 2006; Aggarwal et al. 2009).
[388]Aggarwal et al. 2009.
[389]Aggarwal et al. 2009.
[390]Asset-light industries mean that only some key assets are held by the VIEs but major assets, including property or machinery, belong to the WFOE. (Roberts/ Hall 2011)
[391]Roberts/ Hall 2011.
[392]Ibid.
[393]Schiavenza 2014.

Ma terminated the VIE arrangements in 2010 and transferred the Alipay unit to a private company he controlled himself. Major shareholders of Alibaba Group, including Yahoo! and SoftBank did not have a say in this and only found out months later that the entity they partly controlled just lost its most valuable asset. Eventually the parties agreed to a settlement whereby Alibaba Group could gain from Alipays success and increasing value, yet control over that unit was never retained.[394] From a tax perspective, even though the structure does allow for tax evasion through transfer pricing, profit transfers from the WFOE to the VIE are inefficient. Profits would be subject to double taxation, once business tax accrues when the VIE earns its profit, and once when the money is transferred to the WFOE.

Until now, VIE structures stay within the grey zones of Chinese laws, which also means that the contracts used by the VIE have no legal standing. The PRC government is aware of the structure and its popularity. The absence of regulations prohibiting VIEs is therefore often read as a tacit acceptance of the structure. Despite that, it is neither guaranteed that the shareholders of the VIE respect the contractual arrangement and interests of the shareholders of the offshore company. Nor can it be assumed that the Chinese government will continue to turn a blind eye to it.[395] The structure can be declared invalid by Chinese regulators. Recent examples show that PRC regulatory authorities are inclined to do so in asset-heavy and strategic sectors, like steel production. Buddha Steel Inc. withdrew its IPO in the U.S. in 2011, after local government authorities in Hebei disapproved of the VIE structure.[396] The legal validity and associated risks of VIEs must be reassessed once the new Foreign Investment Law (FIL) will be promulgated.

On 19, January 2015, MOFCOM published a draft of the new Foreign Investment Law for public comments. The draft proposes to standardise the market entry procedures and simplify regulatory requirements for foreign and domestic investors. At the same time, the proposed changes indicate that the PRC government attempts to attain control over investments that are currently out of its reach.[397] Among the major changes that have direct implications for VIE structures are, for one, that VIE investment should be acknowledged and regulated like other types of foreign investments and, secondly, the introduction of the concept called "actual controller", which implies that a company is no longer deemed foreign or domestic based on its place of registration but on who controls the company, including control of equity interests, shares and voting rights or decisive influence on the management through contractual arrangements. If the actual controller is Chinese, the VIE structure is considered legal. If, however, the actual controller is of foreign nationality, the VIE is regarded as a foreign invested company and not allowed to invest in prohibited industries or required to seek entry

[394]Roberts/ Hall 2011.
[395]Schiavenza 2014.
[396]Roberts/ Hall 2011.
[397]Chan/ Zhou/ Huang 2015: 1.

approval for investment in restricted industries. The draft proposes to limit the requirement for government approval, including the pre-approval from MOFCOM and the NDRC, from all foreign investment to foreign investment in prohibited and restricted industries only[398] .[399] Restricted and prohibited industries will soon be identified in a negative list which replaces the four categories system of the Catalogue on foreign investment.[400]

It is still unclear how companies listed overseas and already existing VIE structures will be treated after the promulgation of the new FIL.[401] It is safe to assume that the Chinese government will act cautiously considering the widespread use of the VIE structure. Xu, Schaub and Yao from King & Wood Mallesons law firm speculate that existing VIE structures will likely be considered legal because the companies that have already implemented them are too powerful and influential. Yet, it has to be considered that, when the PRC government rubber-stamps all contractual arrangements of existing VIE structures, it not only approves widespread illegal behaviour and rewards companies that intentionally and openly broke the law but will simultaneously weaken its own legitimacy and power as a law enforcer. It is more likely, that the government will take on a case-by-case approach.

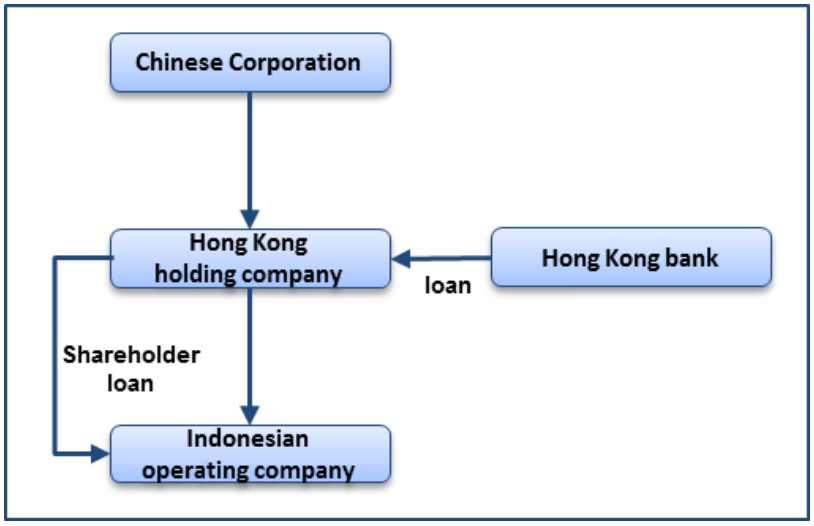
3.5.3. Onward-journeying through interposing one holding company

A third strategy utilising tax havens is the so called onward-journeying. The term was created by Sutherland and refers to companies that use tax havens and OFCs as a platform to raise capital, which is used for further international investment and multinational operations outside of China. This paper addresses onward-journeying by analysing two possible scenarios. First onward-journeying with one holding company is outlined. As most SPVs with Chinese investment are located in HK, the holding company in the first scenario is domiciled there. The second scenario assumes a Chinese business wants to invest in Europa via a holding company in HK and a second one in Luxembourg. This again mirrors a likely construction as Luxembourg is a tax haven that is often used as a platform for investment into Europe. Both scenarios are analysed for possible tax liabilities.

For outbound investment, Chinese companies interpose holding companies in HK or Singapore to take advantage of their DTA regime and favourable tax treatment. The structure entails that a holding company is interposed between China and the target company. The investment is thus channelled through HK or Singapore so that the respective DTA takes effect. The following figure illustrates the tax implications of investment to Indonesia embedded in a HK structure.

[398]Sole exception are the financial sectors. Current restrictions for foreign investment will continue to apply. (Chan/ Zhou/ Huang 2015: 2)
[399]Chan/ Zhou/ Huang 2015: 2
[400]Ibid.
[401]Chan/ Zhou/ Huang 2015: 6-7.

Figure 4: Example of a HK structure with investment to Indonesia



Source: Wolff 2011: 251.

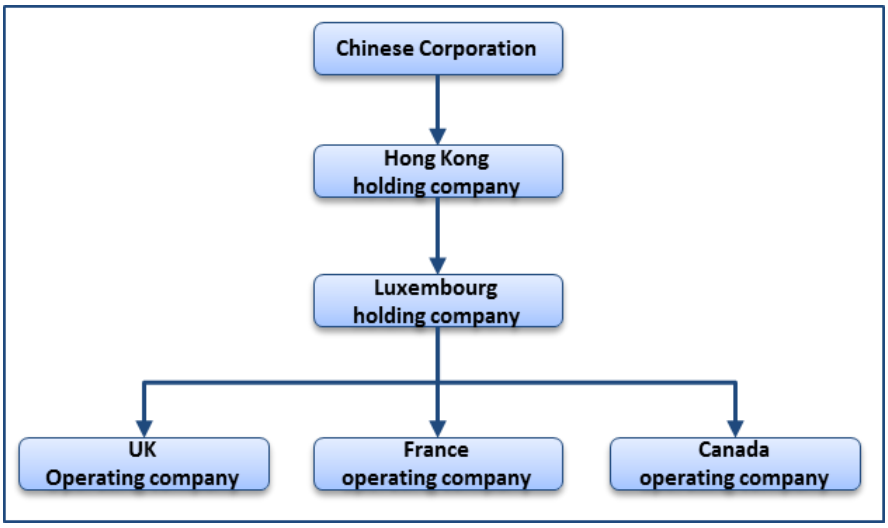
In this scenario, Indonesia levies an EIT of 30 per cent on the income of the Indonesian operating company. The dividends paid to the HK holding company are subject to WHT of five per cent under the DTA, if the HK holding holds at least 25 per cent of capital. If the dividends where paid directly from Indonesia to China a WTH of ten per cent would apply.[402] When the dividends are distributed to the Chinese company, no further WHT is levied in HK, but the dividends are taxed with 25 per cent EIT in China. No further taxation can be expected due to the FTC applicable to the EIT paid in Indonesia. Concerning the shareholder loan, interests paid by the Indonesian operating company is deductible from the domestic tax bill. The interests are subject to ten per cent WHT under the DTA between HK and Indonesia. In HK, the investment is not subject to further taxation. Capital gains deriving from the disposal of shares in the Indonesian operating company are exempt from taxation.[403]

3.5.4. Onward-journeying by interposing multiple holding companies

When Chinese companies want to invest in Europe, interposing intermediaries in two different locations can offer tax advantages in the form of reduced WHT or capital gains tax. One holding company is set up in a jurisdiction favourable from China's perspective, HK or Singapore, and one holding company is interposed in Europe known to offer a broad network of DTAs with Western countries. Examples for this are Belgium, the Netherlands or Luxembourg.[404] Instead of investing directly from China to different European countries, the investment is bundled in a tax haven functioning as a sprinkler head that distributes the investment to the target countries.

[402]SAT 2011: 7.
[403]Wolff 2011: 251.
[404]Wolff 2011: 252.

Figure 5: Example of investment in the EU interposing multiple holding companies



Source: Wolff 2011: 251.

In the scenario of figure 5, dividends paid within the EU are tax exempt. Dividends paid from Canada to Luxembourg are subject to five per cent WHT compared to ten per cent if the dividends were paid directly to China.[405] Dividends from Luxemburg to HK are tax exempt under the Luxembourg-HK DTA. When the dividends are passed on from the HK holding company to the Chinese corporation no WHT is levied whereas five per cent WHT on dividends would apply if the transaction were made from Luxembourg to China directly.[406] In China the dividends are however subject to Chinese EIT. FTC applies to foreign EIT levied on the level of operating companies but limited to third tier subsidiaries. Nevertheless, it might be more lucrative for the investor to retain the dividends in HK and avoid further taxation. The same goes for capital gains. If they derive from the sale of shares in operating companies, they are not taxed in the countries of the operating companies. Further taxation can be reduced if they remain with the holding companies in Luxembourg or HK.[407]

4. Applying tax planning strategies to Chinese case study companies

After theoretically analysing various ways of utilising tax havens in the section above, chapter four will introduce a case study of two companies, a private company and a SOE, to examine the use of the above described strategies in practice. The companies conduct businesses in different industries namely, property development and financial services. Both companies prepared to issue an IPO on the HK stock exchange. In preparation for this IPO they reorganised the company structure adding multiple tax havens to it and incorporated the company about to list in the CI and HK. The HK stock exchange lists the companies as red

[405]Wolff 2011: 525; DFC 1986.
[406]SAT 2011: 11.
[407]Wolff 2011: 252.

chip companies and provides web proof information packages (WPIP)[408]. The WPIPs give comprehensive information about the respective company including the business structure. The sample of companies is not representative for all Chinese companies that incorporate offshore as not all of them undertake an IPO. The case study companies are therefore biased towards those firms that try to acquire international capital. They do, however, provide a particularly good window through which to develop insights into motivations for tax haven uses of Chinese companies and real examples of how tax havens are integrated in the company structure. The chapter proceeds as follows. First the private company called Excellence Real Estate Group Limited is examined. The company is shortly introduced. After outlining the business structure and the changes during the reorganisation, possible tax haven strategies are examined. Afterwards, the state influenced company, Far Eastern Horizon Limited is dealt with in the same manner. Subsequently, findings of the business structure assessment are discussed.

4.1. Excellence Real Estate Group Limited (卓越直业集团有限公司)

Excellence Real Estate Group Limited is a private Chinese property developer incorporated in the CI. It "hired Morgan Stanley and UBS in 2007 to help with an IPO [on the HKSE] targeted for the second quarter of 2008"[409]. The plans for a $1.5 billion listing were upset by the financial crisis. The IPO was then scheduled for 2009 but again postponed due to bad market conditions. Prior to the scheduled IPO, Asian investors had become more selective due to the glut of company offerings and sliding share prices. This constituted an unfavourable starting point for Excellence Real Estate who reduced its planned initial offer of 25 per cent stake in its company to 15 per cent. Even though the founders and brothers, Li Wa and Li Xiaoping, stated to relaunch at a later date, the IPO never went through to date.[410]

4.1.1. Introduction of the company

Excellence Real Estate Group Ltd. was founded in 1996 by Li Hua and his older brother Li Xiaoping. The group develops, leases and manages real estate properties in China. According to Bloomberg the business focuses on two categories of property projects, central business district commercial projects, consisting of shopping malls, hotels or office buildings, and integrated mid-to-high-end residential projects, such as apartments, residential communities or schools.[411] The company is based in Shenzhen.

[408]Since 2007 the HK stock exchange requires new listing applicants "to post an information pack in the nature of a near-final draft prospectus on [the website of the HKSE] prior to the issue of its prospectus." (HKEx 2012: I.U – 2)
[409]Lau/ Tucker 2009.
[410]Ibid.
[411]BloombergBusiness 2016a.

Multiple politically ties can be ascertained. For one, Li Xiaoping was a member of Guangdong province's political advisory body and second, a subsidiary of the group located in the BVI is partly owned by Xi Jinping's brother-in-law, Deng Jiagui. According to the corporate records deposited at the HK stock exchange, the name of the BVI company, which is 50 per cent owned by Deng Jiagui and 50 per cent owned by the brothers, is called Excellence Effort Property Development Ltd. The BVI subsidiary listed the two founders and Deng Jiagui as directors until 2012 when the company was dissolved.[412] Deng Jiagui, who has a professional background in the tobacco industry, married Xi's older sister Qi Qiaoqiao in 1996 and together with her owns luxury property across China and HK.[413]

The group has been in the spotlight of the media ever since the China Leaks made the connection of China's highest man in office to the offshore company public. Moreover, the fact that, within a short period of time, the company received investment in an amount disproportionate to its size drew the media's attention. According to news articles, between 2013 and 2014 the developer spent $3.3 billion on land, three-quarters of the total on three commercial plots in or near Qianhai Economic Zone. The total amount is equal to 134 per cent of the company's 2013 annual sales revenue. Lee puts this number in relation to Chinese developers average spending of 35 per cent of their annual sales each year.[414] The group outbid some of the country's largest real estate companies even as credit in China was tightening and prises in Shenzhen surged about 20 per cent. [415] It has been called into question how the company can fund its business acquisitions. In an interview with Reuters the brand manager stated that funding derives mainly from domestic banks and some trust companies.

4.1.2. The company structure

Figures 7 and 8 show the business structure pre- and post-reorganisation that, according to the WPIP of the HKSE, started in 2007. Moreover, the places of incorporation are given as well as the percentage of ownership of the respective subsidiaries.[416]

Before the reorganisation, Li Wa and Li Xiaoping shared the ownership of Excellence HK Investment Limited. The wholly foreign owned subsidiaries of Excellence HK were the operating companies in China. Excellence Industrial Shenzhen Co. Ltd. was founded as a wholly foreign owned subsidiary in China for the property development operations in Shenzhen. In 2001, when business expanded Excellence Industrial Shenzhen Co. Ltd. was renamed to Excellence China. Project companies with business outside of Shenzhen were established under the Excellence China subsidiary. [417] All operating companies were established as limited liability companies. As shown in figure 7, for some subsidiaries,

[412]Ibid.
[413]Ball 2014.
[414]Lee 2014.
[415]Lee 2014.
[416]Wolff 2011: 192.
[417]EREGL 2009: 96.

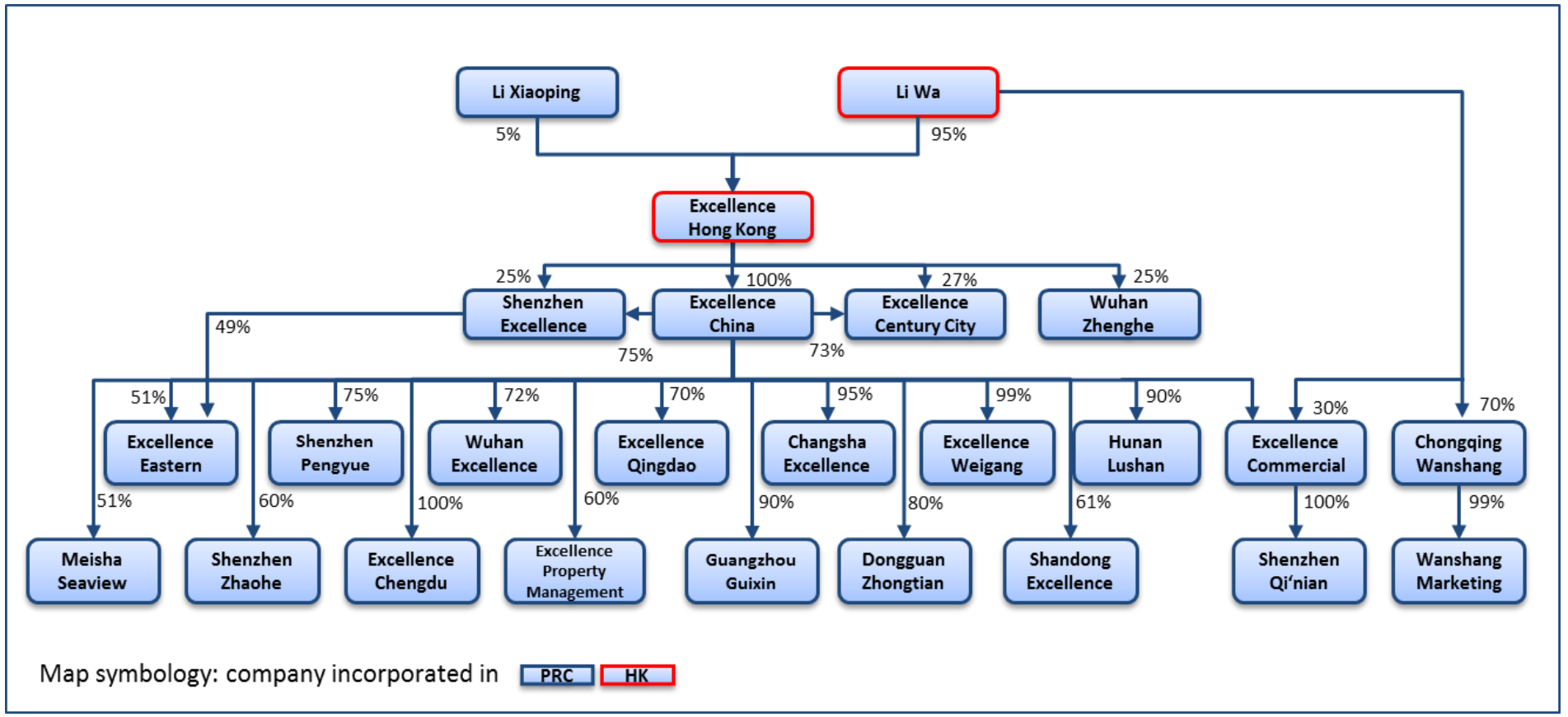
indicated by ownership fractions below 100 per cent, third parties were involved in some of which.

The reorganisation commenced in mid-2007. After the reorganisation, the structure grew highly complex with multiple layers of tax havens. The Excellence Real Estate Group Limited (EREGL) that was supposed to issue the IPO in HK was incorporated in the CI. In February 2008, EREGL became the ultimate holding company of all businesses in the Group when Li Wa and Li Xiaoping exchanged all shares in Excellence HK for shares in EREGL.[418] EREGL was then held as to 95 per cent through Sparkle Century, a business company limited by shares incorporated in the BVI and 100 per cent owned by Li Wa, and as to five per cent through Broad Ocean, a limited investment group also incorporated in the BVI and 100 per cent owned by Li Xiaoping.[419]

Most Chinese operating companies remain subsidiaries of Excellence China or Shenzhen Excellence. Both remain wholly owned by Excellence HK. Excellence HK is part of a three-layered triad structure that is often seen in Chinese companies that incorporate tax havens. The structure consists of Excellence HK owned by Excellence BVI which in turn is owned by EREGL in the CI. One tier below EREGL three BVI companies have been interposed. Apart from Excellence BVI, Joyrun BVI and Jolly Park have been established. Both are isolated with no further connections to the operating businesses in China. In contrast to Joyrun BVI, which has no subsidiaries at all, Jolly Park is the superior holding company for two layers for BVI and HK limited investment holdings. The second tier below EREGL shows an isolated block of mostly three layered ownership structures. The limited investment holding companies incorporated in the BVI each control a limited investment holding incorporated in HK. These in turn have a 100 per cent ownership of operating companies in Shenzhen were the Group is based.

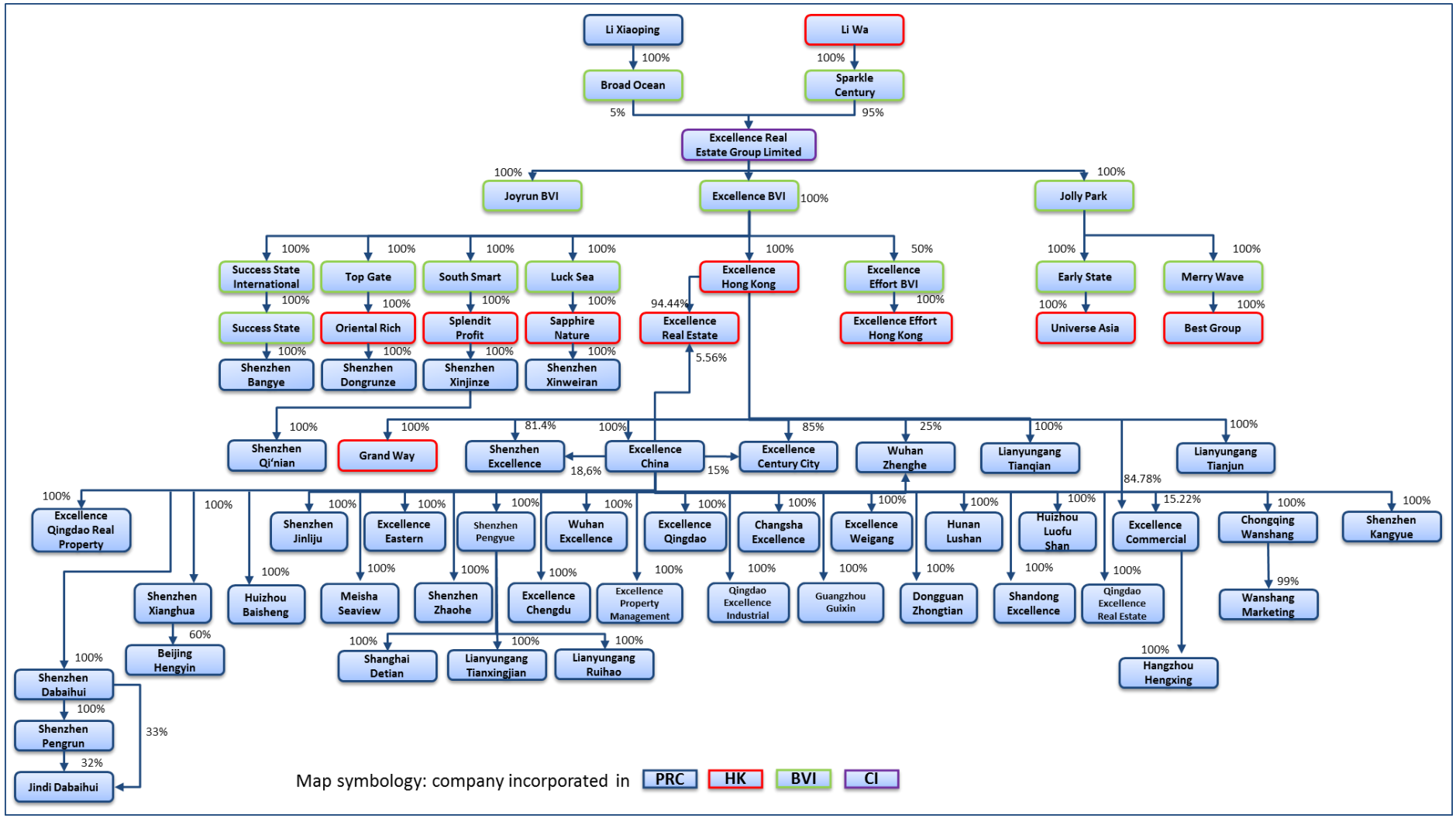
[418]EREGL 2009: 101.
[419]EREGL 2009: 107.

Figure 6: The corporate structure of the Excellence Real Estate Group Limited prior to the reorganisation



Source: EREGL 2009: 102.

Figure 7: The corporate structure of the Excellence Real Estate Group Limited after the reorganisation

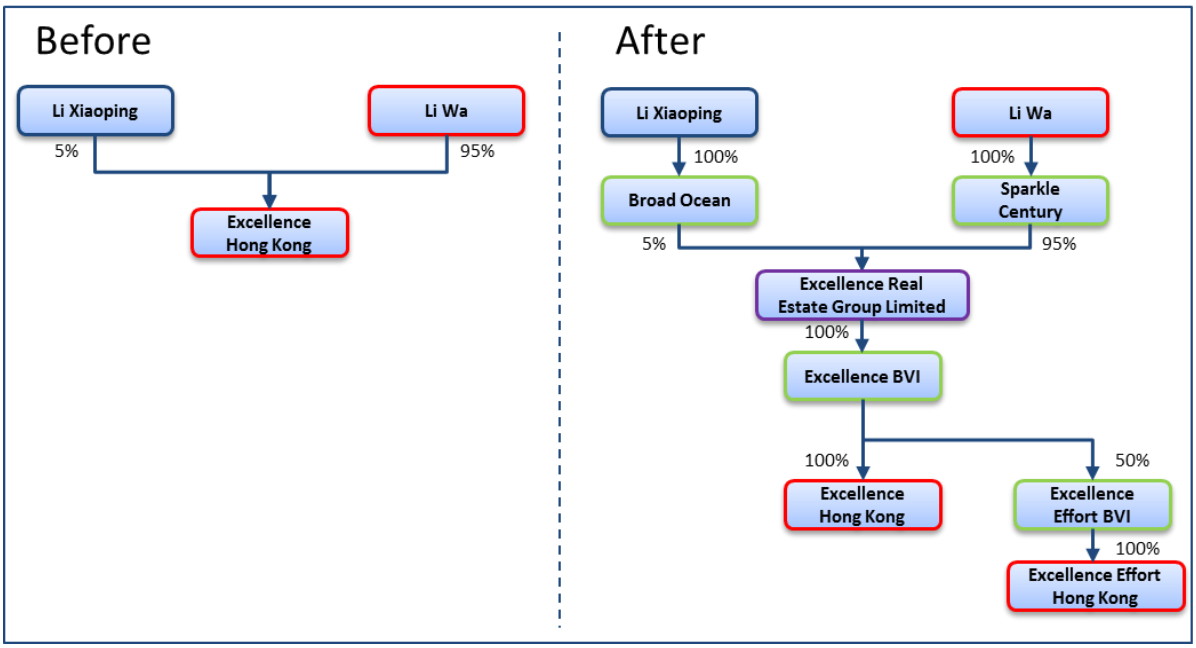


Source: EREGL 2009: 113.

4.1.3. Assessing tax haven structures

Considering that one of the brothers is a PRC resident, this structure could in the broadest sense illustrate a round-trip structure. The brothers might have established the ultimate holding company in HK to take advantage of favourable tax treatment for their foreign investment in China. However, non-tax related motives seem more likely. The incorporation in HK could also be ascribed to the fact that the majority owner Li Wa is a HK resident and establishing a company in his place of residency might be more convenient.

Figure 8: Excerpt of the Group's corporate structure before and after the reorganisation



Source: EREGL 2009: 102; 113.

Moreover, if the brothers planned to acquire international capital from the start, it is not surprising that the Group was established in HK instead of the PRC as international investors are familiar with HK's regulatory business environment and thus are more inclined to invest in companies in HK than China. Moreover, HK is closer to the business primary market and allows Chinese business people to communicate more easily with international investors in their own language. Even though the Group's business activities are strictly limited to China, HK offers a more accomplished regulatory and judicial system for businesses compared to the mainland.

A question that arises from the business structure is why the Group did not simply use a HK holding company to undertake the IPO, but instead initiated a reorganisation and shifted the ultimate holding company to the CI. Moreover, the complex structure shows that the Group has established 13 BVI holding vehicles compared to one in the CI. If the Group prefers BVI vehicles, why did it choose to incorporate in the CI? As already explained before, BVI and CI companies have been used in HK as listing vehicles for a long time because from a business perspective they have some superior features compared to HK holdings. E.g. they offer

companies great flexibility in regards to future tax planning and exit strategies. Excellence HK was probably interposed between the CI parent and the Chinese subsidiaries to that the Group can still take advantage of the HK-China DTA. [420] The reason the Group was incorporated in the CI instead of the BVI is that only CI, Bermuda, China and HK companies were approved for listings on the HKSE at the time of the reorganisation. The BVI were not allowed to list on the HKSE until 2009.[421]

In 2009, dividends in the amount of RMB 400 million were distributed to the shareholders of EREGL, namely Broad Ocean and Sparkle Century. Before the reorganisation, the dividends would have been paid by Excellence HK to the two brothers as natural persons. HK does not levy WHTs on dividends, but in China the money would have been subject to an IIT rate of 20 per cent. After the reorganisation, the money flows from the CI to the holding companies in the BVI and is not taxed at all. Furthermore, the money in the BVI is hard to trace back to the Li brothers and might be more easily concealed from the PRC and HK government.

The reorganisation of the company took place right before the EITL came into effect in 2008. An uncertainty arising from the EITL is that the PRC regards companies as residents and taxes them on their worldwide income, if they are effectively managed from within China. In the WPIP of EREGL, it is stated that a core management team consisting of the two brothers, Wang Dou, Xie Limin, Duan Shijun and Zhang Yuan was formed because of the increasing number of project and operating companies. The core management team was in China and was supposed to remain responsible for the management of the Group after the reorganisation.[422] This means that under the EITL the Group would be considered a Chinese resident. Dividends payable to foreign shareholders would then be subject to WHTs of ten per cent under the PRC tax law instead of no WHTs on dividends in HK or the CI which is an unfavourable precondition for acquiring foreign capital through an IPO. If the foreign investors own a place of business in China or live in a jurisdiction that entered into a DTA with China, the WHT might be reduced.[423] Moreover, as a Chines resident for tax purposes, the Group would be taxed on their worldwide income with 25 per cent EIT. The company was not treated as a PRC resident when the WIP was published.[424] It can be assumed that before the reorganisation it would have been easier for the PRC tax authorities to argue that the Group is a Chinese resident because it was incorporated in the adjacent HK and the business structure was much simpler. After the reorganisation, not only is the Group incorporated offshore in the CI, but also do multiple tiers of offshore subsidiaries cloud the clear connection to the Chinese operating companies as well as the Chinese owners. Moreover, Li Wa, who is part of the core management team and who has a 95 per cent stake in EREGL, is a

[420]Greguras et al. 2008: 1-2.
[421]Woo/ Lee/ Burns 2009: 1.
[422]EREGL 2009:53; 97.
[423]EREGL 2009:53.
[424]Ibid.

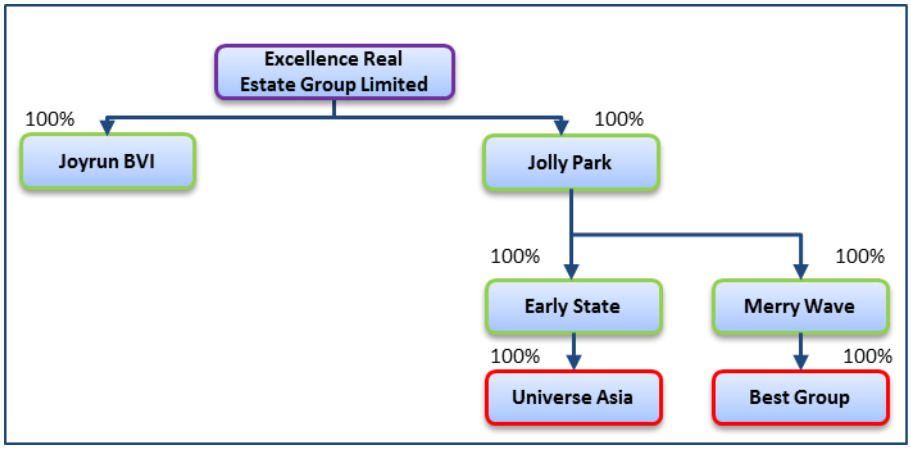
HK resident. These factors might make it more difficult for the PRC tax authorities to trace the effective management of the Group to the mainland.

However, from a tax perspective, being recognised as a Chinese resident can at the same time have financial advantages. The profits of the Chinese operating companies are subject to Land appreciation tax (LAT) at rates ranging from 30 to 60 per cent depending on the land value, BT and CIT.[425] The BT amounts to five per cent for revenues from property development and property rental. Three per cent BT and surcharges at various rates payable to local tax authorities apply to revenues from property management.[426] If EREGL, Excellence BVI and Excellence HK were deemed PRC resident companies, WHT on the dividends from the Chinese operating companies to the controlling companies would be eliminated because dividends from one PRC resident to another are exempt from WHT. Otherwise, dividends from China to HK are subject to 20 per cent WHT.

The business structure after the reorganisation shows the limited investment holding company in the BVI, Excellence Effort BVI, and its wholly owned subsidiary in HK, Excellence Effort HK. The BVI company is held as to 50 per cent by the Li brothers and is as to 50 per cent controlled by Deng Jiagui, Xi Jinping's brother-in-law. Even though an ongoing discussion connects relatives of the Politburo elite to take advantage of their family's political connections, a political connection per se does not conclusively prove the BVI company is used to evade taxes or hide money deriving from corruption and bribery. On the one hand Deng Jiagui is a real estate tycoon, who together with his wife and Xi Jinping's older sister Qi Qiaoqiao, is linked to "at least 25 companies over the last two decades in China and HK either as shareholders, directors or legal representatives"[427] and has owned multiple properties in HK with his wife.[428] Deng Jiagui's involvement in this company could therefore simply be a business arrangement. On the other hand, Deng Jiagui and his wife have been traced solely to holding companies on the mainland or HK, this holding company however is incorporated in the BVI and only lists Deng Jiagui as part-owner. The only subsidiary is established in HK with no operating business activity. As Deng Jiagui sources a substantial amount of his income in HK with companies in the same industry, this can offer opportunities to shift money or avoid taxation without raising suspicion.

[425]EREGL 2009: IA-75.
[426]EREGL 2009: 227.
[427]Bloomberg News 2012.
[428]Ibid.

Figure 9: Excerpt of the group's corporate structure after the reorganisation I



Source: EREGL 2009: 113.

Figure 9 shows subsidiaries of EREGL that are limited investment holding companies incorporated in the BVI and HK. None of which have direct connections to the operating companies. Isolated companies within a corporation might indicate income shifting activities.

In general it is less complicated to concentrate all IP in one jurisdiction and let the IPR holding company enter into license agreements with the various local operating companies. This helps to avoid different tax regulations and tax treatment in different jurisdictions and respective DTAs. Furthermore, in our case the income from the Chinese operating companies can be shifted e.g. to Joyrun in the BVI. By channelling the royalties via HK to the BVI instead of paying it directly from China, the Group can take advantage of the China-HK DTA and reduce WHT on royalties from ten to seven per cent.

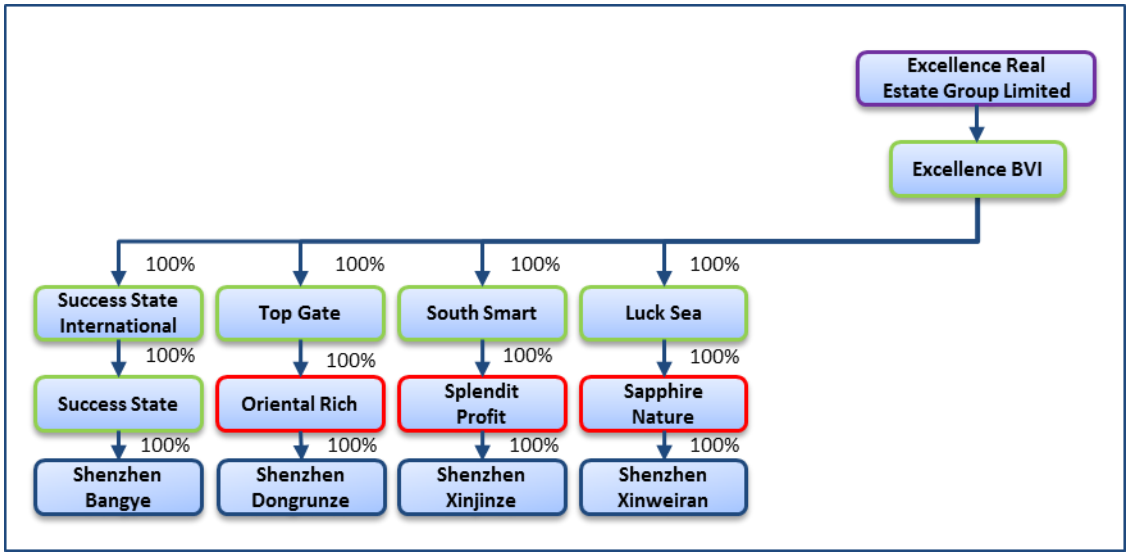
Figure 10 shows another extract from the business structure, where a selection of Shenzhen based operating firms are each owned by one holding vehicle in HK or the BVI, which each in turn function as subsidiaries to another tier of BVI holdings. This tier is then through its parent holding Excellence BVI connected to the Group structure. The reason why these four domestically operating companies were decoupled from the others is probably because they are inactive according to the WPIP.[429] It appears costly and lavishly to set up two holding companies for a single company that does not even yield any profits. Maybe it is easier to handle inactive subsidiaries this way or to dissolve them when they are not tightly connected to other Chinese companies.

A question that arises from the whole reorganised business structure in general, but can be seen particularly well in figure 10, are the multiple interposed BVI holdings between the CI parent company and the HK subsidiaries. It can be assumed that the ultimate holding company in the CI and Excellence BVI are sufficient to implement all the tax planning strategies, the Group is seeking for. Further tax haven holdings seem dispensable. Perhaps,

[429]EREGL 2009: IA17.

the additional tax havens serve a "better safe than sorry" approach and further cloud origins and destinations of investment streams. Another possibility is that this very complex restructuring might be out of proportions for the Group but very much in the interest of the agency that consulted EREGL on this undertaking. The new structure is so complex and high maintenance that it might create a lock-in-effect and a long-term dependency of the EREGL on the consultancy.

Figure 10: Excerpt of the group's corporate structure after the reorganisation II



Source EREGL 2009: 113.

To assess non-tax related motives, this part refers to risk factors that were identified by the Group in the WPIP in relation to the institutional environment of China in general and of the real estate sector in particular. These risk factors might indicate reasons other than tax advantages why the Group chose to incorporate their company offshore. Not all risks and uncertainties companies face in China can be avoided through offshore incorporation. Nevertheless, they give insight into domestic obstacles companies in China struggle with and might constitute push factors.

In the WPIP, the Group stated that general risks when conducting business in China involve extensive government regulations and laws that are often subject to change or interpretation creating an unstable business environment and leading to arbitrary implementation. Especially foreign exchange regulations and currency control are adversely affecting business activities. Other risks are low IPR and property protection. The latter might lead to the PRC government reclaiming the company's land. Finally, the quality of facts and statistics from China might be questionable and thus unreliably.[430]

The WPIP also lists risks that are directly related to the real estate industry in China. Some of which are that the PRC government controls the land supply to property developers and can

[430]EREGL 2009: 12-15.

obstruct the company's attempts to obtain suitable land.[431] The Group requires many licenses and certificates to conduct business in the real estate industry and thus depends on the goodwill of local officials. If certificates, e.g. property ownership certificates, are denied or issued too late, costs can arise for the Group or for its customers.[432]. The WPIP also states that the "PRC government has implemented restrictions on the funding abilities of PRC property developers"[433]. The real estate market in China is volatile especially price fluctuations derive from frequent government interventions in the form of policy adjustments.[434]

4.2. Far East Horizon Limited (远东宏信有限公司)

Far East Horizon Limited (FEHL) is a financial service provider incorporated in HK. The controlling shareholder of the company is the state-owned conglomerate Sinochem headquartered in Beijing. Sinochem falls under the supervision of SASAC. Its core business activities involve the chemical and oil industry.[435] In contrast to private EREGL, FEHL thus offers insights into a company under massive state influence.[436] FEHL was the first Chinese leasing company to list in HK after its IPO on the HKSE in 2011 during which it raised US$660 million.[437] This chapter takes a closer look at the company structure of FEHL before and after the preparation process for the IPO in 2011.

4.2.1. Introduction of the company

Far Eastern was founded in Shenyang in 1991 as an equity joint venture enterprise. At first the state-owned Sinochem[438] and China Construction Bank Corporation of China[439] owned together 50 per cent of the shares. Other shareholder included Japanese banks which were heavily affected during the Asian financial crisis in 1997-1998. That was when Sinochem Conglomerate acquired the interests of all other shareholders and consolidated its control.

During the course of the restructuring, the operational centre of Far Eastern was relocated to Shanghai to strengthen its market position and horizontal business expansion.[440] The company business operations within the healthcare industry, machinery, printing and shipping among other were commenced and multiple regional offices were established. [441] Sinochem continuously increased the registered capital so that it amounted to US$60,470,000 in 2004

[431]EREGL 2009: 12-14.
[432]EREGL 2009: 14.
[433]EREGL 2009: 14, 55.
[434]EREGL 2009: 15; 55.
[435]Sinochem 2015.
[436]FEHL 2011: 82.
[437]Wu/ Hu 2011.
[438]In 1991 the Sinochem Group was named China National Chemicals Import & Export Corporation. (FEHL 2011: 82)
[439] In 1991 the China Construction Bank Corporation was under the name People's Construction Bank of China. (FEHL 2011: 82)
[440]FEHL 2011: 82-83.
[441]Ibid.

and was intensively involved in Far Eastern's business strategy development. Since 2008 FEHL is established and incorporated in HK.[442] Other structural changes will be discussed in the subsequent chapters.

FEHL provides customised financial services and solutions in the PRC, HK and other countries. The company operates in two segments, Leasing Factoring and Advisory, as well as Industrial Operation. The former offers direct financial leasing, sale-leaseback, factoring and advisory services. Industrial operations involve import and export trade, and domestic trade of medical equipment and parts, as well as paper, ink, cardboard, and paper goods primarily for the healthcare and printing industries, and provision of ship brokerage services, medical engineering, operating leasing and hospital and healthcare management services as well as trade agency services primarily within the machinery industry. The company also provides installation and engineering, and construction services.

The typical leasing business entails, that the customer acts as a lessee and selects an asset that FEHL will buy. As a lessor FEHL will rent the asset to the customer for rental payment that will in the end together with interest set off the costs of the purchase. After the leasing term expires, the customer can buy the asset and obtain ownership of it. The ship financial leasing business is conducted through the HK subsidiary.[443]

4.2.2. The company structure

The company has undergone many restructuring processes since its establishment in 1991. This part will only focus on the restructuring processes that prepared the company for a listing in HK. Figures 11 to 13 show the business structure pre- and post-reorganisation and provide information on the places of incorporation as well as the percentage of ownership of the respective subsidiaries.

The analysis starts with the business structure that prevailed immediately before FEHL was incorporated in HK in 2008. Figure 11 illustrates that Far Eastern was a wholly owned subsidiary of Sinochem Conglomerate. The majority shareholder was Sinochem Group in Shanghai, who owned 75 per cent of Far Eastern's equity interest. Sinochem HK controlled the rest. The two operating subsidiaries, Shanghai Donghong and FOTIC, were both located in China. Far Eastern owned 90 per cent and ten per cent of the subsidiary's equity. The remaining shareholders were subsidiaries of Sinochem Conglomerate. Overall, the business structure was very straight-forward and simplified.

Starting in 2008, Far Eastern commenced a series of reorganisations. It incorporated FEHL in HK and turned it into the ultimate holding company of the main operating entities.[444] In the

[442]BloombergBusiness 2016b.
[443]FEHL 2011: 4
[444]FEHL 2011: 85.

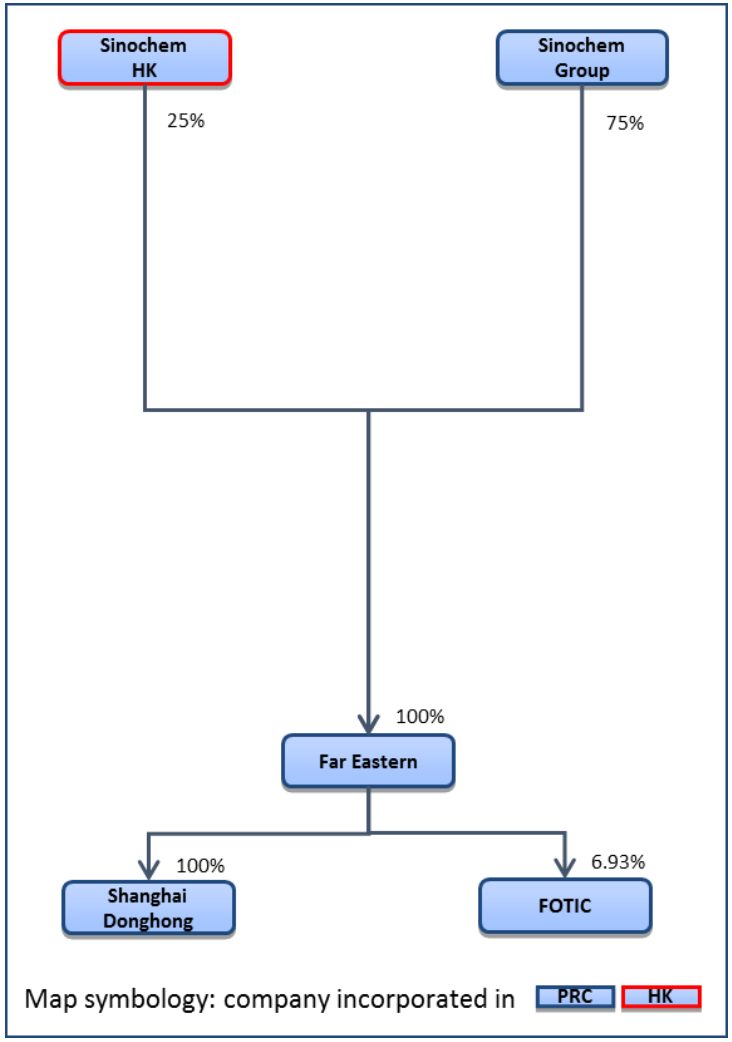
same year, an offshore restructuring of the shareholding company was initiated. The results are visualised in figure 12. Sinochem acquired Fortune Ally, a Cayman holding company. Fortune Ally in turn became the sole shareholder of FEHL and was thus interposed between Sinochem and FEHL. In 2009, a wholly-owned subsidiary and investment vehicle of Sinochem Group incorporated in the BVI called Greatpart acquired all shares of Fortune Ally and thus became the parent holding of Fortune Alley and an indirect holding company of FEHL.[445]

The final restructuring process before the IPO resulted in the business structure outlined in figure 13. In comparison to before, the structure then included multiple different tax havens. The process entailed two major processes, on the one hand FEHL expanded into the shipping industry and on the other hand the shareholding structure was again altered. In 2009, FEHL acquired FEH Shipping, a company incorporated in the CI, for offshore ship leasing and ship brokerage business. To help undertake that business, 78 SPVs located in HK that were under the control of FEH Shipping were transferred to its HK subsidiary Far East Ship in 2010. According to the WPIP of FEHL, this shareholding transfer served the purpose of separating different business foci. While Far East Ship and its 78 subsidiaries were supposed to engage in offshore ship leasing business, the remaining HK subsidiaries, China Bloom Shipping Ltd, FEH Chartering Co., Ltd and Full Earn Ltd were aimed at other businesses such as ship brokerage. Each SPV was managed separately and handled one financial leasing contract, which implies that for each leased ship a HK SPV was established.[446]

On the other hand, three international investors, namely KKR Future Investments, Techlink and TML, became direct controlling shareholders of Fortune Ally to increase FEHL's expertise on international financial services.[447] KKR Future Investments is incorporated in Luxembourg and belongs to KKR Asian Funds LP, an exempted limited partnership incorporated in the CI. Techlink is incorporated in Mauritius and ultimately held by the Government of Singapore Investment Corporation (Ventures) Pte. Ltd.. TML is incorporated in HK and ultimately held by CICC Fund, one of China's leading investment banking firms and the first one to receive approval from the CSRC to raise and manage private equity funds in 2010.[448] Upon completion of the investment restructuring in Fortune Alley, Sinochem Group's stake in Fortune Ally, the holding company, through which Sinochem controlled FEHL, was reduced to 68 per cent.[449] Right before the IPO in 2011, Fortune Alley distributed all of its shares in FEHL to the four investors in proportion to their respective shareholding and ceased to be the direct parent holding of FEHL.[450]

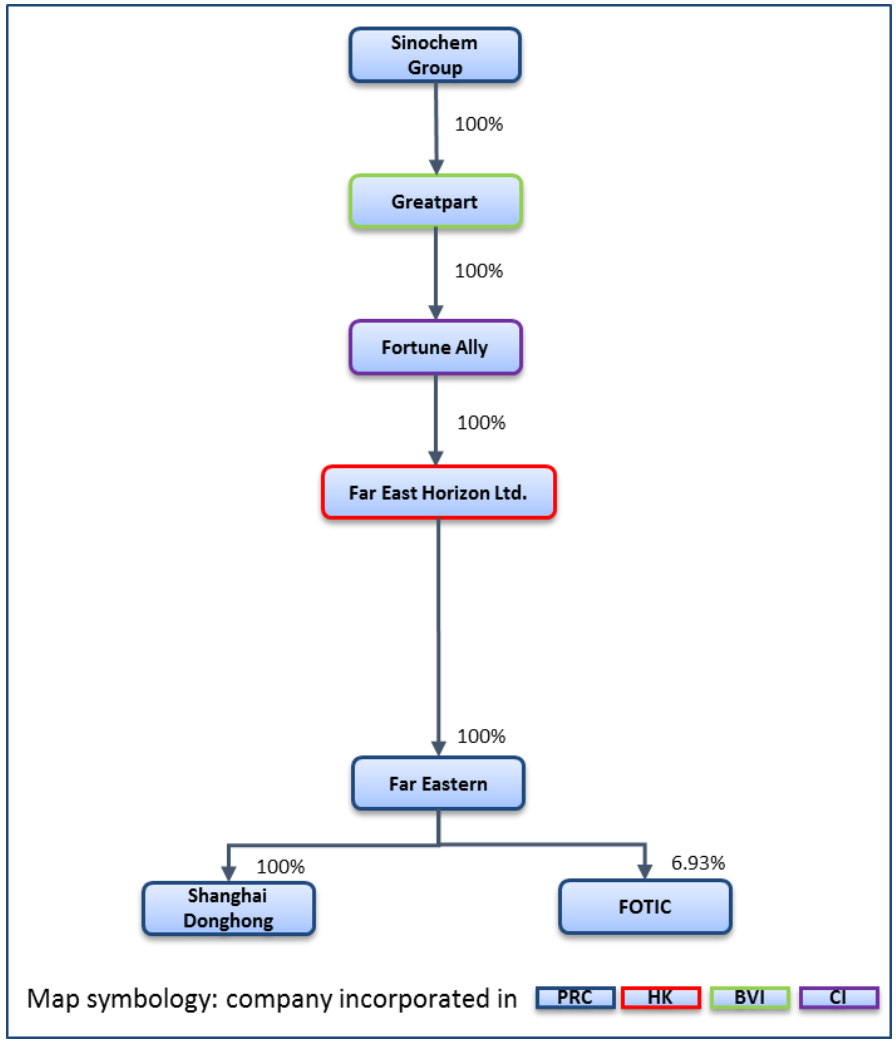
[445]FEHL 2011: 85.
[446]FEHL 2011: 86-87, 93.
[447]FEHL 2011: 87.
[448]FEHL 2011: 92.
[449]EFHL 2011: 81.
[450]FEHL 2011: 94.

Figure 11: The corporate structure of Far Eastern before the reorganisation



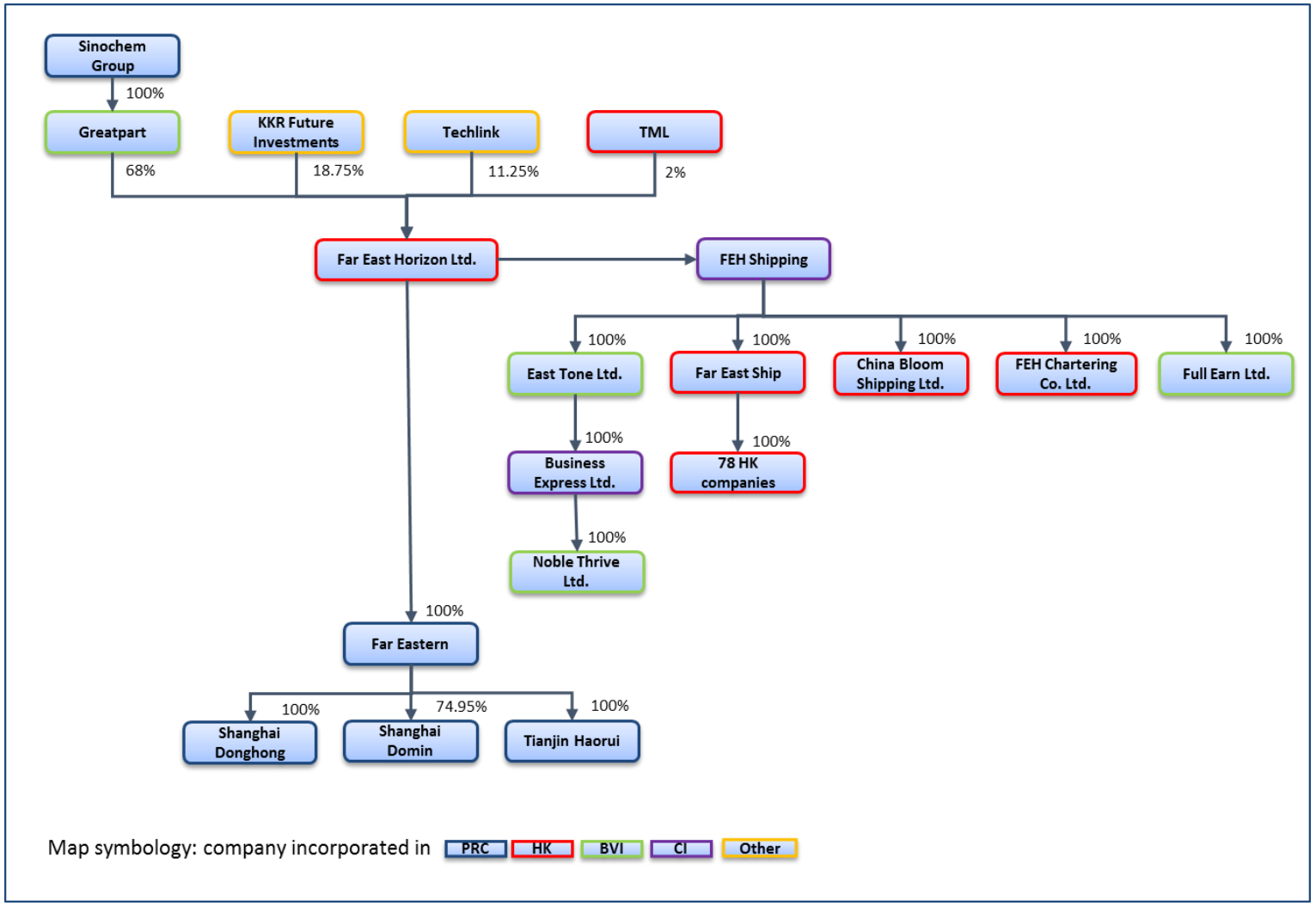
Source: FEHL 2011: 84.

Figure 12: FEHL after the reorganisation of shareholders



Source: FEHL 2011: 86.

Figure 13: The corporate structure of Far East Horizon Ltd. after the reorganisation



Source FEHL 2011: 91.

4.2.3. Assessing tax haven structures

As figure 12 reveals, when the shareholder structure was restructured, Sinochem chose to adopt the same triad arrangement that was identified in EREGL's business structure. Sinochem controls FEHL through two tiers of holding companies incorporated in the BVI and the CI respectively. In contrast to EREGL, the company issuing the IPO is this time incorporated in HK and not in the CI. While in the first company example at least two out of the three tax havens served a purpose, namely the CI for flexible incorporation environment and HK for the IPO as well as a favourable DTA with China, the example of FEHL only has HK providing real functions and leaves the implementation of a BVI and a CI holding open for interpretation.

One possible explanation could be related to the fact that the structure in figure 12 can definitely be identified as a round-trip structure. The ultimate controlling shareholder, Sinochem Group, is a PRC resident and channels its investment through the BVI and the CI holding as well as the FEHL in HK back into China. Sinochem might have tried to conceal its involvement in this round-trip arrangement by interposing multiple tax havens.

In general, it seems surprising that an SOE engages in round-tripping. The primary motive for round-tripping since 2008 was identified as capital accumulation. SOEs are supported by the state and have easier access to funding than private companies that must resort to offshore listings to finance their business. SOEs can also list much easier on the domestic stock exchange and collect funds there. If, however, the intention of this company was to accumulate international capital, it seems reasonable that it chose to list in HK instead of China. As has been established before, international investors are much more inclined to invest in the HK stock exchange than in the Chinese.

An additional explanation for the triad structure is related to the EITL. FEHL is currently not treated as a Chinese resident for tax purposes. Its income source in HK is subject to HK CIT of 16.5 per cent. To avoid the declaration of a Chinese resident for tax purposes, the company perhaps has deliberately chosen to incorporate in HK in 2008, the year when the EITL took effect. The triad structure might help conceal that FEHL is ultimately controlled and owned by a Chinese resident. If the company will be considered a resident enterprise its worldwide income will be subject to 25 per cent PRC CIT. Furthermore, dividends paid to foreign investors and capital gains deriving from the share transfer would then be charged with ten per cent PRC income tax. It is uncertain if other company subsidiaries that are incorporated offshore will also be identified as resident enterprises. If so, dividend distributions between them would be exempted from taxation.[451]

[451] FEHL 2011: 44.

Figure 13 shows that immediately prior to the IPO, all four direct shareholders of FEHL were incorporated in tax haven, Greatpart in the BVI, KKR Future Investments in Luxembourg, Techlink in Mauritius and TML in HK. Even though many tax havens are involved, this arrangement might partly be related to genuine business motives. International shareholders were added to increase FEHL's expertise and help with its international business. On the other hand, all shareholders are ultimately linked to Asian parent companies in Singapore or China. Singapore is an accomplished OFC, why is it necessary to invest in a HK company via a European or African tax haven? The reason behind this might be related to the financial services industry these businesses engage in. Luxembourg and Mauritius offer highly developed financial services. As the businesses involved in our case are all providers of such financial services, it does not appear far-fetched that they chose to go to those countries that have the biggest market for their business.

To assess non-tax related motives, this part refers to risk factors that were identified by the Group in the WPIP in relation to the institutional environment of China. These risk factors might indicate further reasons other than tax advantages why the Group chose to incorporate tax havens in their business structure. Furthermore, they might give insight into domestic obstacles companies in China struggle with and thus pushes them offshore.

In the WPIP, the FEHL states that general risks relating to conducting business in China include that the Chinese economy is less accomplished than the economies of developed countries. In China, a high degree of government involvement as well as control of capital investment might adversely affect the business of FEHL. Moreover, the success of FEHL hinges on domestic demand. An economic downturn could affect the financial situation of FEHL's customers and curb their demand for FEHL's services. Moreover, the taxation on the local level is not in accordance to the tax law. Before the EITL, Far Eastern, located within the Pu Dong New District of Shanghai, enjoyed a preferable tax rate of 15 per cent. According to PRC legal advisors, there was no legal basis for this reduced tax rate which is why Far Eastern perhaps will have to repay taxes amounting to RMB2.5 million for the year 2007.[452] FEHL depends on the dividends paid by the PRC operating subsidiaries. As this entails that the revenue of the subsidiaries is in RMB and has to be transferred across borders to HK, the dividends from the subsidiaries to FEHL might be limited by China's currency exchange restrictions.[453]

4.3. Discussion of findings

Due to the limited scope of this thesis, the number of research cases is small. The findings of this assessment therefore must not be generalised for all Chinese companies. Nevertheless, the

[452]FEHL 2011: 42-43.
[453]FEHL 2011: 40.

findings help identify overall trends, shed light on structural patterns of Chinese tax haven usage and feed into the current discussion.

The results of the assessment yielded that tax havens play a major role for Chinese companies irrespective of whether a company conducts business in China or internationally or whether the company is private or state-owned. Considering that governments all over the world blame tax havens for the erosion of their tax base, it seems surprising that the Chinese government itself chooses to take advantage of tax havens when the possibility arises. Nevertheless, the state-owned company appeared to resort to tax havens rather with a pure business motivation and legitimate tax planning intentions. Even though it is impossible to identify tax evasion in a business structure with complete certainty, concerning the structure of the private company, the sheer number of tax havens alone seems dubious and with some tax havens the motivation behind their incorporation is questionable. Suspicion is further aroused by the fact, that Deng Jiagui, a princeling, is involved in the tax haven activity. Deng is a real estate tycoon might indicate that his involvement is a legitimate business arrangement. Considering, however, that if he really engaged in business activities with EREGL, it seems unrealistic that he can be linked to just one company in the BVI that is not even an operating company. All of these findings suggest that EREGL is involved in illegal tax haven activity.

However, the conclusion that SOEs or companies with governmental influence in general are per se not involved in tax evasion or other illegal tax haven related activity cannot be drawn. Nor do the findings establish that private companies have a higher tendency to do so. Both, private and state-owned companies, can benefit from tax havens. Private companies are faced with domestic restrictions and resort to tax havens to acquire international funding to become more competitive at home or internationally. Thanks to governmental support, SOEs have an edge over private companies in the domestic market. This has the negative side effect that SOEs struggle with efficiency. When going against international conglomerates in the global market, Chinese SOEs can improve their competitiveness at least from a tax perspective.

Moreover, a structural pattern can be identified. Both companies implemented a triad structure involving two holding companies in the BVI and the CI with a HK subsidiary. It is beyond the author's knowledge if this structure is limited to Chinese companies only. Nevertheless, it can be assumed that it is very typical for investment into China irrespective of the investing company's nationality.

The finding of this triad arrangement can help interpret China's investment statistics. The three tax havens were already linked to China's round-trip schemes, yet the statistics only allowed the conclusion that money from either the BVI or the CI is channelled back into China via HK. The findings of this chapter reveal that when China round-trips money it very likely channels the investment through both the CI and BVI before it returns to the mainland via HK.

A question arising from the triad structure is why a third offshore holding has to be interposed between the CI and HK or the BVI and HK as a double structure would be sufficient to cover tax planning intentions. The following company motives can be presumed. Either the triad structure helps conceal the round-tripping motives of the company or controlling shareholding entities that do not want to be linked to the company interpose multiple tax havens to increase the secrecy. Another explanation is related to China's EITL and suggests that companies that don't want to be identified as Chinese residents for tax purposes, try to obscure their linkages to Chinese parent companies.

The assessment of the business structures and the examination of risk factors identified by the companies themselves, confirm that China's weak institutional framework and restricting business environment is a major push factor and gives companies plenty incentive to go offshore. Once China improves its performance, Chinese tax haven activity might diminish. On the other hand, once China's economy catches up with those of developed countries, China might simply shift its motives. Chinese companies might continue to engage in tax haven activity, but instead of doing so for the purpose of escaping China's restrictions, they perhaps align their motives with those of developed countries and engage primarily in tax arbitrage.

5. Conclusion and outlook

The purpose of this paper was to examine the relevance of tax havens for China. An analysis of China's investment statistics revealed that tax havens play a very important role for China. In fact, the multitude of tax havens obscures official data. Investment data only encompasses direct investments to initial jurisdictions, which in China's case are often not the ultimate destination. It is therefore concluded that Chinese investment data is unreliable when trying to understand China's genuine investment streams. It is also assumed that the real amount of tax haven usage might even be higher compared to what the statistics stipulate.

The tax havens used most frequently by China are HK, the BVI and the CI. This triad of country is highly connected to China related investment and commonly involved in round-trip streams of Chinese residents.

Furthermore, the analysis of Chinese motives for tax haven activity revealed that they differ from those of Western companies. While Western companies use tax havens mainly for the purpose of tax arbitrage, Chinese companies are pushed to engage in tax haven activity by China's weak institutional framework and restrictive business environment. Especially private companies are affected. Access to funding from banks or applications for listings on the domestic stock exchange is often denied. Being former British colonies, HK, the BVI and the CI offer laws and regulations that international investors are familiar with. International

investors are therefore more inclined to invest in companies that are incorporated there. Private businesses thus incorporate in tax havens to list on stock exchanges in HK or the US to accumulate capital for their business activities. Deriving from this, with respect to China, tax havens often function as financial intermediaries for foreign investors that want to invest in China or Chinese firms that want access to international capital.

The scope and the repercussions of China's illegal tax haven activity should not be underestimated. China's identified corruption problems involving Chinese officials were linked to China's tax haven activity. Despite the current anti-corruption campaign launched by China's President Xi Jinping, many Chinese officials and successful business moguls are connected to multiple holding companies in the Caribbean. Even though being linked to tax haven activity not necessarily constitutes involvement in capital flight or tax evasion, some of the identified Chinese residents have been convicted for bribery or insider trading. Corruption and tax havens allow rich people to increase their wealth and further promote income inequality, which already is an issue China severely struggles with. If corruption and inequality continue to prevail or even exacerbate, it could have detrimental effects on China's society, economy and threaten the legitimacy of the Chinese government. Therefore, even if the number of illegal tax haven usage is negligible in comparison to legitimate business activities, it is essential to include illegal tax haven activity when assessing the relevance of tax havens for China.

Three major tax haven strategies were introduced and discussed, namely round-tripping, VIE structures and onward-journeying.

Round-tripping entails that Chinese residents channel money via a tax haven back into China for domestic business expansion. It was revealed that the motives behind that strategy have altered over the years. Before 2008, investment coming from a tax haven was deemed foreign investment and subject to a favourable tax regime. In 2008 a new tax law took effect and eliminated the tax advantages. Round tripping nevertheless remained a very important investment strategy. Chinese businesses continued to implement it to accumulate offshore capital.

An analysis of investment streams between China and the triad revealed that the promulgation of the new ETIL has induced that direct money streams from the BVI and the CI to China are decreasing. Instead, investment to China is now increasingly routed via HK. The reason behind this new trend is presumably that investors want to take advantage of the China-HK DTA.

Variable interest entity structures allow investors to circumvent Chinese market restrictions. When it comes to FDI, the Chinese government classifies industries into four categories, namely industries for which FDI is encouraged, permitted, restricted and prohibited. Variable

interest entities are companies that work in industries blocked for foreign investment. These VIEs nevertheless want to acquire foreign capital. In order to do that they for example give foreign investors access to licences issued only to Chinese companies. This can be accomplished through the variable interest, which refers to the fact that a Chinese domestic company is controlled by foreign investors not through equity but through a complicated arrangement of contracts.[454] This is better captured in the Chinese term for VIE which is 协议控制 (xiéyì kòngzhì) and means control exercised through agreements. VIE structures have however, no legal standing as they are within the grey zone of Chinese law and can be declared invalid by Chinese regulators. Even though VIEs have grown in popularity over the last 15 years, the many inherent and external risks indicate that this tax haven strategy will very soon lose in importance.

The term onward-journeying refers to companies that use tax havens and OFCs as a platform to raise capital, which is used for further international investment and multinational operations outside of China. The strategy was outlined in two possible scenarios. First onward-journeying with one holding company was addressed. As most SPVs with Chinese investment are located in HK, the holding company in the first scenario was domiciled in HK. The second scenario assumed a Chinese business wants to invest in Europa via two holding companies. One holding company interposed in HK channelled the money out of China and the other holding company was interposed in Luxembourg a favourable hub for investment into Europe. Both scenarios were analysed for possible tax liabilities, which indicted that HK's popularity as a hub for investment from and to China is to a great degree attributable to a DTA between China and HK. This DTA offers the lowest tax rates among all of China's DTA's.

In the fourth chapter, findings and insights from the previous chapters were applied to analyse tax haven motives of two case study firms. As both case study firms intended to issue an IPO on the HK stock exchange, they deposited a comprehensive information package. These information packages provided a detailed outline of their business structure that was the basis of the subsequent assessment.

The selection of companies included a private and a state-owned company so that the identified findings could be compared. As both companies intended to list on a stock exchange, the motives were biased towards those firms that try to acquire international capital. Due to the limited scope of this paper, only two companies were examined. The findings can therefore not be generalised. Despite these biases and limitations, the two case study firms do provide a particularly good window through which to develop insights into motivations for tax haven uses of Chinese companies and real examples of how tax havens are integrated in the company structure.

[454]Schiavenza 2014.

The first company is called Excellence Real Estate Group Limited (EREGL). It is a private Chinese property developer. Prior to the reorganisation, the company was incorporated in HK, with solely Chinese operating subsidiaries. During the reorganisation, the group incorporated in the CI and added multiple layers of BVI and HK holding intermediaries to the business structure.

The second company is a state-influenced financial service provider named Far East Horizon Limited (FEHL). The reorganisation of the company was divided into two steps. First the company based in Shanghai and ultimately wholly owned by a state-owned entity (SOE) was incorporated in HK. In addition, CI and BVI holding companies were interposed between the HK incorporated company and the SOE parent. After the second reorganisation process, the shareholding structure was altered resulting in three external investors, all of which incorporated in tax havens, sharing ownership of FEHL with the SOE. The company further expanded its business portfolio and acquired the CI holding company FEHL shipping to offer ship leasing and ship brokerage business. To help undertake that business, 78 SPVs located in HK were put under FEH shipping control.

Prior to the IPO, both companies reorganised their business structures and integrated multiple tax havens. The magnitude of tax havens found in the business structures emphasised the importance of tax havens for Chinese companies, irrespective of whether the company is an SOE or private, or conducts its business in China or internationally. While the reasons why the state-influenced company incorporated tax havens into their structure seemed to be related to legitimate business motives, the motives behind the structure of the private company appeared rather questionable. The sheer number of tax havens as well as the involvement of Deng Jiagui, Xi Jinping's brother in law further fostered the suspicion that EREGL is involved in illegal tax haven activity including tax evasion and capital flight.

Additionally, a structural pattern could be identified. Both companies implemented a triad structure involving two holding companies in the BVI and the CI with a HK subsidiary. It is assumed that this triad arrangement is typical for investment into China.

In relation to the triad structure the question arose why a third offshore holding has to be interposed between the CI and HK or the BVI and HK as a double structure would be sufficient to cover tax planning intentions. The following company motives were assumed. Either the triad structure helps conceal the round-tripping motives of the company or controlling shareholding entities that do not want to be linked to the company interpose multiple tax havens to increase the secrecy. Another explanation is related to China's EITL and suggests that companies that don't want to be identified as Chinese residents for tax purposes, try to obscure their linkages to Chinese parent companies.

The assessment furthermore confirmed that China's weak institutional framework and restricting business environment is a major push factor and gives companies plenty incentive to go offshore. Once China improves its performance, Chinese tax haven activity might decline. If private companies were treated equally to SOEs when it comes to funding, they would no longer be forced to resort to tax haven listings. Furthermore, lifting restrictions on FDI into certain industries would make tax haven strategies like the VIE scheme redundant.

What counters this line of argumentation is that developed countries do have a transparent and accomplished institutional environment. Companies nevertheless engage in tax haven activity. This could imply that when China catches up with developed countries, companies might simply engage in tax haven activity to the same extent as before, but instead of doing so for the purpose of escaping China's restrictive business environment they perhaps align their motives with those of developed countries and engage primarily in tax arbitrage.

To curb tax haven activity resulting from corruption in China, officials and party cadres should be required to disclose their financials. China also needs to take a leaf out of HK's book and have independent parties and non-officials scrutinise anti-corruption efforts. If China fails to curb corruption the integrity of Xi Jinping and his anti-corruption campaign might be called into question.

Further research into this matter could examine how China has affected the development of Caribbean tax havens. As tax havens are heavily dependent on Western countries, it would be interesting to see if increasing Chinese demand for tax haven activity either causes tax haven dependency to shift from Western countries to China or causes tax havens to grow more independent. If the latter is the case, pressure from OECD and G20 countries on tax havens might likely remain fruitless.

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Erklärung

Ich erkläre, dass das Thema dieser Arbeit nicht identisch ist mit dem Thema einer von mir bereits für ein anderes Examen eingereichten Arbeit. Ich erkläre weiterhin, dass ich die Arbeit nicht bereits an einer anderen Hochschule zur Erlangung eines akademischen Grades eingereicht habe.

Ich versichere, dass ich die Arbeit selbständig verfasst und keine anderen als die angegebenen Grundlagen benutzt habe. Die Stellen der Arbeit, die anderen Werken dem Wortlaut oder dem Sinn nach entnommen sind, habe ich unter Angabe der Quelle der Entlehnung kenntlich gemacht. Dies gilt sinngemäß auch für gelieferte Zeichnungen, Skizzen und bildliche Darstellungen und dergleichen.

_____ Würzburg, 24.02.2016