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Financial Sector and its Role and Activities within International Tax Planning

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Abstract. This contribution monitors position of banks in international tax planning. From this perspective, there are two views, by which the banks have to be seen: banks as intermediary and banks as multinational companies with interest in reduction of their tax liabilities. Banks can be assistants for their clients when it comes to the tax avoidance but there are differences between their attitudes to clients with tax avoidance tendencies. Clients of banks mainly accents financial secrecy, in which Switzerland is consider being one of the best. Banks' tax avoidance is different problem and there are also differences between them in this case. Countries, which are magnet in their profit shifting schemes, are Luxembourg or Ireland in EU and some of the Caribbean islands. Clients and banks prefer different countries in their tax planning activities and this is caused by their different needs. On the one hand, clients appreciate secrecy, on the other hand, banks' profit shifting process does not require it at the first place and they can focus on reducing of their tax costs or changing location for investment purposes.

Keywords: Tax Planning, Financial Sector, Tax Havens.

1 Introduction

Nowadays, use of tax havens in business activities is one of the most discussed themes when it comes to multinational companies. Tax avoidance is not a new thing and companies use international tax planning for decades. This area is also important for countries' governments because they try to offer the best condition for multinationals. On the other hand, not all countries tend to attract multinational companies therefore this situation can result in lower tax revenues of state budget. All that means that tax planning is a topic for every country in the world.

From the perspective of the Czech Republic, tax havens are also important because there are many multinational companies, which operate on the Czech market. These companies have possibilities to shift their profits into different subsidiary or to parent company of the group. Furthermore, even small companies can use tax havens in these days because information technologies bring this possibility also to them.

There arise few key questions, when the tax planning is studied. First of all, which countries can be identified as tax havens? Second, how the multinationals use them to lower their tax burden. It is difficult to answer both questions because the answer cannot be stated in general. Tax planning is complex process and its attributes differ from one company to another. Whereas the countries, which want to attract multinational companies from other countries, use different tools, every single company faces decision if the concrete legislation aspects of taxation are profitable for it. It brings to the third question related to the use of tax planning: has a field of the company an impact on selection of countries where the multinational operates and where shifts its profits? One problem related to this question lies in that needs of every company is different and characterized specific field in general can be too much simplifying. On the other hand, there are several specific groups of firms, which tend to have similar behavior in tax avoidance activities. One of them are multinational companies from financial sector, especially banks. This study deals with situation and position of banks in tax avoidance activities.

2 Statement of the problem

Whereas the legislation of different countries accents usually only several aspects of taxation, the multinationals select their subsidiaries locations and location of the parent company according to their specific preferences. It is obvious that some companies from certain field can have similar needs related to tax legislation.

How the field of the company influences tax planning activities can be characterized in several ways. One of them is study from De Simone et al [4]. This paper studies *"the relation between income shifting aggressiveness and corporate investment efficiency."* [4] They use *"a transformation of the Cobb-Douglas production function to model affiliate-year reported profits as a function of capital, labor, productivity, and tax incentives."* [4] Within their model, they use median of the ROA by industry as the measure of the productivity between variables. [4] For the results, locations of investments are influenced by tax planning activities. [4] This study does not result in any information about the particular sector but it is important to see that industry-level variables are important for experts, which study international tax planning.

Delgado et al include information about the field of the company in the set of determinants of effective tax rates [5]. Their study is based on real data of EU companies from company database and they study key attributes, which influence the effective tax burden. The variables for the sectors are dummy variables for each monitored sector. For the results, there are more influential variables than sectors, in which companies operate [5]. According to this study, the *"size, inventory intensity and profitability"* are the main key drivers of effective tax rates [5]. On the other hand, when the company has relatively higher effective tax rate, the debt becomes the most influence variable [5].

Also experts from OECD address tax planning activities of companies with respecting of sectors' factor. Sorbe and Johansson monitor situation of investments and their relation to the tax burden [11]. They study tax planning activities and investment activity on industry level data (from World Input-Output Database) and on firm-level data (from ORBIS database) [11]. Results of their industry level regression show that higher effective tax rates result in lower investment activity [11]. These results do not provide any information about concrete type of sector. On the other hand, further results show that attributes of industry can have effect on investment activity because *"the presence of MNEs with profit-shifting incentives is found to reduce significantly the tax sensitivity of investment."* [11] When there are relatively many multinational corporations with tax avoidance activities in the particular industry, tax burden of companies does not have such an effect on investment activity [11].

Overall, the sector analysis is not very frequent. Experts include this aspect in their studies but their models show that there are more important drivers of tax planning activities. This study shows how the current literature sees the situation of tax planning from the perspective of financial sector, concretely banks. This specific sector is the point of interest of many experts because its significance predetermines it to the importance of knowledge its international tax planning activities. For the banks, it has to be mentioned that it can be viewed from two angles on their role in tax avoidance. First of all, banks and legislation related to their business belong to the most important aspects of business environment when the countries are evaluated from the perspective of their use as a tax haven. Second, the banks themselves are able to use tax haven for reducing their tax liabilities.

3 Role of the banks

Banks are important part of tax avoidance process because the cash flows have to be mediated by someone. Second, the amounts of money have to be deposited somewhere therefore banks are significant helper in international tax planning. Therefore banks and information which they have are at the center of tax authorities' interest.

3.1 Banks as part of international tax planning

Role of the banks is frequently discussed topic in several studies. One of them is from the European Union expert Karel Volckaert [14]. First of all, he shows the significance of tax havens and tax planning in modern days. The importance of banks in tax planning is often seen in hiding of information about owners or about cash flows related to bank accounts. From the perspective of frequently used countries, there is the biggest amount of wealth held in Switzerland [14]. Even more, banks are financial institution which provides financial resources and cash flows between different accounts. Therefore banks can cooperate one tax planning activities with other multinational companies [8].

Often used scheme to avoid paying taxes can be called as *"investing in mutual funds through a tax haven account.*" [14] When the resident in particular country has a foreign account in a different country, where banks shield information, he can avoid paying taxes in a home country in certain situations. Tax authorities from the home country cannot reach the information about his activities and they are not able to taxed them. Another way, how banks are incorporated in tax planning activities, is that they lend money to the parent company. This parent company applies expenses before taxation. Then *"the proceeds of the loan are invested in shares of a subsidiary residing in a low-tax rate jurisdiction."* [14] Then this subsidiary provides a loan to another part of the group, which resides in the country with relatively high tax burden [14].

The role of the banks is also important in offshore centers. There is almost impossible to uncover the beneficial owner of a bank account or investments. Activities to hide the owner identity are very often motivated by tendency towards covering some illegal activities or tax evasions. Volckaert mentions e.g. *"code-name accounts"* as a frequently used banking product related to tax planning [14]. Bank accounts in these countries are also used for hiding assets, which should be taxed according to legislation in different country.

There are also studies, which are focused on quantitative analysis of bank activities in international tax planning. Paper from Gallemore et al belongs to this group of studies [8]. They capture *"bank-client relationships using lending contracts and measuring borrower tax avoidance".* [8] Results of their regression model show that banks play an important role in international tax planning [8]. For the concrete facts, banks have different attitude related to the *"tolerance for substantial tax avoidance by their borrowers."* [8] These findings are important for better knowledge about banks and their activities. There is significant difference between banks and their position as tax avoidance assistant. Some banks tend to provide tax avoidance services and be helpful with tax planning, the others are not so engaged in these activities. Their results also suggest *"that the average tax avoidance of a bank's other borrowers is an economically important determinant of a client firm's own tax avoidance."* [8] Banks are important part of tax planning and there are also activities with goals of sharing information about tax avoidance schemes between their clients.

3.2 Financial Secrecy Index

Financial secrecy can be one of the important of legislation attributes, which can play a role in setting a location of parent or subsidiary or even for persons. Organization called Tax Justice has developed Financial Secrecy Index, which expresses the situation of countries related to their role as secret tax haven.

Several attributes of business environment are included within analyzation of financial secrecy. It is important to mention that the methodology of this calculation consists not only from taxation aspects of legislation but also other areas are included. First area is *"Knowledge of beneficial ownership".* [7] This aspect becomes the most important one when the owners tend to hide their identity. Of course, this hiding can be done from personal reasons but the most probable reason is practicing of tax evasions. There are three types of indicators which addresses banking sector's secrecy and legislation aspects of providing information about ownership of the company [7].

The second area is called *"Corporate Transparency"* [7]. Indicators within this part target public availability of information about the corporation. The next area addressing country's tax legislation itself and it is called *"Efficiency of tax and financial regulation"* [7]. The last indicators include *"International standards and cooperation"* [7].

For this study, the most important are first group of indicators which address situation of the financial sector in the country. This indicator monitors situation about information about customers of banks [12]. This availability of information about accounts held at the banks is meant for the tax authorities. The results of this part of the index demonstrates that there several countries which provides relatively secretive conditions related to banking. The lowest score defined as *"transparency credit"* have Andorra (0.23) and Barbados (0.27) [12]. For example Luxembourg has a score at the level of 0.3. For the comparison, Germany and France have this value about 100 % higher. Also countries like Switzerland or Liechtenstein have the value lower than other countries in Europe and their index is at the similar level as the countries from Caribbean. It can be seen that countries like Luxembourg and Switzerland provides great conditions in terms of banking secrecy.

Overall results of the Financial secrecy index for 2015 show that the country with highest financial secrecy is Switzerland [6]. Selected countries and their results are presented in Table 1.

Table 1. Financial Secrecy Index (FSI) for Selected Countries in 2015 [6]

Rank	Country	FSI	Secrecy Score
1	Switzerland	1,466.1	73
2	Honk Kong	1,259.4	72
3	USA	1,254.7	60
4	Singapore	1,147.1	69
5	Cayman Islands	1,013.1	65
6	Luxembourg	816.9	55
⋮			
73	Slovakia	60.1	50
75	Poland	57.2	36
81	Czech Republic	44.2	35
84	Hungary	37.3	36

Higher ranking have achieved also other tax havens, e.g. Honk Kong, Singapore, Cayman Islands and Luxembourg [6]. There are two other countries, which position is notable: USA and Germany. These two countries often claim that they suffer from the tax avoidance activities but this index ranks them to the best alternatives in terms of financial secrecy. Positions of the countries from Visegrád Group are in the seventh and eight tens.

It has to be mentioned for the best interpretation of this index that the weight represented by *“share in global financial services exports”* has significant effect on the resulting value of FSI [6]. For comparison of legislation, the secrecy score has higher explanatory power. In the case of this score, the Switzerland has one of the highest but there are countries with more than 80 points, e. g. Samoa or Liberia [6]. On the other hand, there is significant difference between Visegrád Group countries in Secrecy Score and countries at the top of the table because Switzerland or Hong Kong provides better conditions in terms of secrecy.

4 Banks’ tax planning activities

There are also studies, which try to explain tax avoidance activities applied by banks. One of them is from Aubrey and Dauphine, whose studied tax planning activities of the European banks. Based on data form 2015, they analyzed not only, which tax havens these banks use but also how they use them and the extent of their tax planning activities.

Luxembourg and Ireland are the favorite tax havens for European banks [1]. Studied banks had about 8.4 percent of worldwide profits in these two countries [1]. Apparently, Luxembourg and Ireland are used for tax planning because this proportion does not copy the size of countries. Naturally, the proportion of profits should correspond with market size of the country and scope of activities in such a market. This study shows that banks generally have higher profits in tax havens than they naturally should have in terms of turnover or number of employees [1]. In concrete numbers, there are only 7 % of employees in tax havens but banks reported profits there are about 19 percentage points higher than this value [1]. Mentioned disproportion is also shown by banks’ profit per employee, which is significantly higher in countries considered as tax havens [1]. Concretely, one employee working in part of the group on Cayman Islands brings almost 6.3 million of profit [1]. For the understanding of tax planning activities, mentioned findings have crucial importance because data proves that banks profits are shifting to certain countries, which are often considered as tax havens.

Situation of banks in Europe is even more complicated due to the political view on them in different countries. The biggest banks in Europe are multinational companies originally reside in some of the “old” EU countries. This also corresponds with set of banks in mentioned studies, where are companies coming from France, Germany, Italy, Netherlands, Spain, Sweden and the United Kingdom [1]. These banks operate on several countries in Europe and some countries’ markets (e.g. these from Visegrád Group) are dominated by these multinational banks. From the perspective of the governments, they are facing threat of lower tax revenues because these multinational companies have not only the possibility of shifting their profits but also their center of interests is set in different country so there are two reasons for shifting their profits to the different country. Therefore there are countries which apply special tax levied on banks, e.g. Hungary [13]. On the other hand, there is also study providing result that the higher tax burden of banks is compensated by increased fees or interests [3]. Therefore the solution of special tax for banks is not sustainable.

Experts from international organizations also notice that the financial sector has specific position related to use of tax havens. European Commission's study from 2017 targets banks' tax avoidance activities. [2] This study is based on Oxfam research (mentioned above) but the experts from European Commission have extended the set of banks included in the study to the level of 36 banks. [2] The study aims to geography of bank's activities with emphasis on use of tax havens. They *"analyze the determinants of banks' commercial presence abroad within a standard gravity framework"* and they *"rely on a Poisson pseudo-maximum likelihood to account for zeros."* [2] The model is based on level of turnover, which bank has in different countries. Firstly, the model is used without taking into account whether the country is considered as tax haven or not. For the results of this model, size of the economy of particular country and number of citizens positively affect the level of turnover [2].

Three other variations of the model consider the fact, how the particular country is seen in terms of taxation. Coefficients expressing if the country is tax haven or not, are positive in all three variations of them [2]. These three models but only deal with the fact if the country belongs to tax havens. They do not consider any specific attribute of the legislation or business environment in general to characterize the level of attractiveness for tax planning activities.

Therefore their study continues with identification of significant specific drivers [2]. For the results of these drivers, they have found *"an unexpected positive sign of the coefficient associated with the effective tax rate suggesting that the larger the tax rate the larger the activity of banks"* [2]. Other results show that banks tend to seek stable countries in terms of governance and business environment. The level of taxation is not the only key factor for the banks for selection of locations including in tax planning activities. Banks from the EU use as tax havens mainly Luxembourg, Isle of Man and Guernsey [2].

There is also s study, which monitors tax planning activities of banks from the Czech Republic [9]. This study is also based on country-by-country reporting data, which leads to better knowledge about tax avoidance. This study covers the five largest banks operate at the Czech market [9]. All of them are part of multinational groups and they operate there through their subsidiaries. From the perspective of only Czech banks, the situation is similar to the other European banks. It makes sense because the biggest banks operating at the Czech market also belong to the biggest in terms of whole Europe. For the countries, which they use within international tax planning, Luxembourg, Ireland and Hong Kong are the most frequently used [9]. A huge amount of profit also ends in countries, where the parent company of the group resides, e.g. Austria and Belgium [9].

Murphy's study is based on the same dataset and is also focused on banks' tax planning activities [10]. His study shows that there is a difference in extent of European banks' profit shifting [10]. Some of them reallocated above 30 % of turnover and there are also few for which this indicator is below 10 % [10]. There is also significant difference between countries when it comes to profit shifting.

According to Murphy's study, banks declared relatively bigger profits in USA, Belgium, Luxembourg or Ireland [10]. On the bottom of the chart are Spain, UK or Switzerland [10].

5 Discussion and conclusion

Overall, the banks are important objects of interest when the international tax planning is studied. Their role as intermediary is known for years and the ways, how the tax avoidance can be done, constantly evolve. In this case, the banks have different position. Reviewed studies show that some of them manage or contribute to tax the tax avoidance practices of their clients. But there are also group of banks which are not active in tax planning. Study from Gallemore shows that there is no significant difference in terms of type of institution or type of clients [8]. It seems that clients practicing the tax avoidance are concentrated in certain banks.

From the perspective of other aspects of banking sector, the financial secrecy is an important thing. It has to be mentioned that this unwind form the legislative and the banking system of particular country. It is not only the attitude of banks but the regulation play the key role. Countries, which are often considered as tax havens (or at least as bank havens) like Switzerland or Hong Kong, provide relatively secret condition for their clients. Whereas the legislation is the main thing in terms of banking secrecy, countries with higher FSI can be seen as tax havens which want to be attractive as final stop of profit shifting.

When it comes to banks as a multinational companies practicing profit shifting, studies are based on the data from country-by-country reporting. For better results, data from further years have to be including to the further studies as soon as it become available. Results of analysis of this data provide a lot of information about concrete banks and countries which they use as tax havens. Overall, there are differences between banks and some of them do not practice tax avoidance, at least do not shift profits in huge amounts. Countries considered as tax havens are favorite for banks when they decide where to shift their profits. Not even the European ones like Luxembourg or Ireland but also several Caribbean islands. From the perspective of the Czech Republic, one fact is important: multinational banks operating on Czech market prefer next to the mentioned tax havens also home countries of their parent company. Further research should focus on new datasets related to the multinational banks and studied their activity in several consecutive years. Also the detailed analysis of tax havens' legislations should be beneficial.

Interestingly, there is also significant difference between countries. Some of them, which are known for the financial secrecy (like Switzerland) are not so popular when it comes to banks' profit shifting activities itself. It is caused by different interests of banks and their clients. Financial secrecy (in terms of banking privacy) is more important for clients than for the banks. Clients are more sensitive to sharing of information because personal taxation is based on tax residence and people, which want to avoid paying taxes, ten to hide information about part of their income. On the other hand, banks or other multinational companies focus on reduce their tax liabilities. Whereas they have a lot of opportunities to change the profit distribution within the group, hiding of information is not for them so important.

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