

TAX MANAGEMENT THROUGH TAX HAVENS COUNTRY, TRANSFER PRICING AND PROFIT SHIFTING (With special reference to Indonesia case)

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ABSTRACT

Although taxes affect numerous aspect of our life's and influence nearly all business decisions, their impact is not uncontrollable. Given an understanding of the rules, taxes can be managed with considerable success. Effective systems of tax management are vital to any profit oriented organization. Successful management, however, is predicated on good tax management

The obvious goal of most tax management is the efficient amount or reducing the amount of taxes that a person or other entity must transfer to the government. The legal efficiency of taxes is usually referred to as "tax avoidance", while the use of illegal means of reducing taxes referred to as "tax evasion" (unilateral and bilateral) and should never be tolerated

Every nation claims the right to tax income originating within its borders. However, national philosophies regarding the taxation of foreign source earning differ and this is important from a tax management perspective.

Tax considerations on international operation strongly influence decisions on where to invest, what form of business organization to employ, how to finance, when and where to recognize elements of revenues and expense, and what transfer prices to charge. With the possible exception of cost of goods sold, taxation is the larger expense of most businesses. It makes sense for management to minimize international taxes when ever possible, through tax havens country, transfer pricing, and profit shifting

Keywords: tax management, tax havens country, transfer pricing, profit shifting

INTRODUCTION

The practical consequences of the study of taxation are varied. But this fact should stand out – taxes affect us all. Various aspect of one 's personal life are affected by tax rules. These rules can be significant in such personal transactions as: selling a residence, paying an obligation, investment in stocks or bonds, handling marital settlements, estate planning and record keeping.

Business transaction are also influence by the rules of taxation. Some of these are: buying and selling business property, handling of mortgage, liquidating or reorganization a business and transaction between an employer

and employees. Taxation is a significant component of the financial executives function and a significant factor in business performance

Although taxes affect numerous aspects of our life and influence nearly all business decisions, their impact is not uncontrollable. Given an understanding of the rules, taxes can be managed with considerable success. Effective systems of tax management are vital to any profit oriented organization. Successful management, however, is predicated on good tax management

Tax management is simply the process of arranging one's actions in light of their potential tax consequences. It should be emphasized that the tax consequences some times turn on how a particular transaction is structured – that is, form is often controlling

The obvious goal of most tax management is the efficient/the minimization of the amount that a person or other entity must transfer to the government. The legal efficient /minimization of taxes is usually referred to as “tax avoidance”, while the use of illegal means to efficient/minimize taxes referred to as “tax evasion” and should be never be tolerated

Tax management is a completely legal means for saving taxes. The basic idea is to arrange your activities as to avoid the impact of the tax law as much as possible. Thus opportunities for effective tax management are greater when tax effects are given consideration before transaction are finalized rather than afterward. Before-the-fact tax management requires that decision makers be constantly alert for tax-saving alternatives in the every conduct of their affairs. In other words, the first requirement for effective tax management is tax awareness on the part of decision makers rather than tax expertise by tax professionals

In addition to his technical skills a tax manager should have a sense of balance and the ability to exercise judgment. For example, the tax savings which a particular proposal might achieved should be considered in comparison with its complexity and the costs of it implementation, which include not only the expenses of establishing it but also possible charges to other taxes and the cost of subsequently administering it

AVOIDANCE VERSUS EVASION

Everyone agrees that there is a fundamental difference between “evasion” and “avoidance”; but as we shall see, the distinction often become hazy in theory as well as in application. Taken in its plainest sense, “tax evasion” should connote the attempt, whether successful or not, to reduce or altogether to eliminate tax liability by means which the statutes declare to be unlawful; while “tax avoidance” should connote reaching the same end by lawful means. This basic draw a-line concept between lawful and unlawful means of reaching the same end.

Conceptually, the distinction between evasion and evasion is the difficulty in stating the distinction; certainly no one has suggested two better term to denote two things that are wholly different in the law. The difficulty of stating a distinction does not necessarily mean absence of distinction. It may be true that from one view point any recognizable distinction is pragmatic, avoidance being what works, and evasion being what fails. But this statement of distinction does not take us very far. It is necessary to know why there is success in the one instance and failure in the other. So broadly stated the distinction is far from accurate. Attempted avoidance will fail if the taxpayer misconceives the law; the fact that he had guessed wrong can hardly convert his attempted avoidance into evasion. On the other hand, evasion sometimes unfortunately succeeds through the failure of the

administrative process to reach the attempt. This failure of enforcement officers to detect can hardly convert evasion into avoidance.

UNDERGROUND ECONOMY

Tax administrators face a formidable number of challenges in every country. In many developing countries, including Indonesia, tax administration reforms are needed simply to achieve macroeconomic stability. From year 2007 up to 2010, our country has been reformed four tax laws, e.g. General Provisions and Tax Procedure Law, Income Tax Law, Value Added Tax and Sales Tax on Luxury Goods Law and Regional Tax Law, in responding to the demands of a growing market economy, the resulting increase in the number of taxpayers, and the need to establish the legitimacy of tax collection.

Although the self-assessment process requires all entities subject to tax to file a tax return and accurately their income and deduction items, not all taxpayers comply. Tax revenue losses due to non compliance, called the tax gap, usually measured based on the underpayments of taxes by only legitimate or legal business ventures and money-making activities. No estimates of the illegal sector tax gap (from illegal drug sales, prostitution, and so on) are considered reliable. The estimated tax gap includes both underreported income and overstate deductions

The popular term, “the underground economy” , is inexact, encompassing a wide range of economic activities. In part, this is reflected in the fact that there are so many adjectives used to describe this aspect of the economy: black, cash, covert, dual, grey, hidden, illegal, informal, invisible, irregular, marginal, moonlight, parallel, second, shadow, subterranean, twilight, under-the-table, unobserved, unofficial, unrecorded, unreported, are only sample.

Investigators have developed complicated taxonomy’s of” underground economies” Some of the more important distinction are drawn between legal and illegal income, market and self-performed services, income that should be taxable and income that should be recorded in governments statistical accounts, and income that should be taxable and income that is derived from activities that do not meet other government regulatory requirements. Basically, the term the underground is used here to refer to the value of economic activity that would be taxable were it reported to the tax authorities. But, of course, even this not represent the amount of additional revenue that would be collected by stricter enforcement. No one suggests that it should be possible to tax all of the ncome generated in economy. Moreover, stricter enforcement would significantly affect the economic response of individuals in the underground economy- some firms would go bankrupt, taxpayers would modify their labor supply, prices and income would change, and so on. The tax base would clearly be altered because of stricter enforcement, Thus even the imperfect measures of tax gaps must be interpreted cautiously.

In recent years most commentators agree there has been a growth in the size of the underground economy. By definition, the underground economy exist because of government taxes and regulation. Therefore, it seems to make sense that the more taxes and regulation, other things being equal, the larger the underground economy is likely to be. Beside of this factor, the other factors that have been referred to a growing the size the underground economy: (a) Increase in Means-tested Transfer (b) Stagnating Real Incomes and Increases in Unemployment, (c) Increase in Self-employment, (d) Shift to Services, (e) Changing Demographics, (f) Forces of Globalization (g) Decline in tax morality

Tax Management that I will explain it in this paper is one of the underground economy that exist among others from factors of “Increase Burden of Taxes and Government Regulation” and “ Forces of Globalization” Whatever governments do, the combined effects of information technology and globalization are likely to make it easier for businesses to hide in the shadows in future. Many transactions conducted over the Internet, for example are hard to track, increasing the scope for dodging taxes. Globalization also makes the tax collector’s job harder as more individuals receive payments from work or investments abroad, which are more difficult for national authorities to monitor.

THE INCOME TAXATION SYSTEM

Every nation claims the right to tax income originating within its borders. However, national philosophies regarding the taxation of foreign source earnings differ and this is important from a tax management perspective. A few countries such as, France, Costa Rica, Hong Kong, Panama, South Africa, Switzerland, and Venezuela adopt the territorial principle of taxation (territorial income taxes) and exempt from taxation the income of resident corporations generated outside their borders. This reflect the idea that tax burdens of foreign affiliates should equal those of their local competitors. In this view, foreign affiliates of local company are viewed as foreign companies that happen to be owned by local residents

Most countries (e.g. Australia, Brazil, China, the Czech Republic, Germany, Japan, Mexico, the Netherlands, the United Kingdom, the United States and Indonesia) adopt the worldwide principle (global income taxation) and tax resident corporations and citizens on income regardless of national boundaries. The underlying idea here in that a foreign subsidiary of a local company that happens to operate abroad. The worldwide principle results in double taxation, because the income is taxed where earned and then again to the parent company. However, double taxation is mitigated by tax credits, tax treaties, tax havens, the deferral principle, and tax exemption.

Technology and the global economy are challenging many of the principles on which international taxation is based. One of these principle is that every nation has the right to decide for itself how much tax to collect from the people and businesses within its borders. Tax laws evolved in a world where transactions take place in clearly identifiable locations, but this situation is increasingly less true. Electronic commerce over the internet ignores borders and physical location. Commercial events now take place in cyberspace-on a server anywhere in the world.

The ability to collect taxes depends on knowing who should pay, but increasingly sophisticated encryption techniques make it harder to identify taxpayers. Anonymous electronic money is a reality. The internet also makes it easy for multinationals to shift their activities to low tax countries that may be along way from customers but as close as a mouse to click to access. It is more difficult to monitor and tax international transactions.

Tax considerations on international operation strongly influence decisions on where to invest, what form of business organization to employ, how to finance, when and where to recognize elements of revenues and expense, and what transfer prices to charge. With the possible exception of cost of goods sold, taxation is the larger expense of most businesses. It makes sense for management to minimize international taxes when ever possible, through tax havens country, transfer pricing, and profit shifting

TAX HAVENS COUNTRY

A phenomenon that has emerged from the philosophy that foreign source income should not be taxed at all or should be taxed only when declared a dividend is the tax haven. A tax haven is defined as “a place where foreigners may receive income or own assets without paying high rate of tax upon them” Tax havens offer a variety of benefits, including low taxes or no taxes on certain classes of income. Because of these benefits, thousands of so-called mailbox companies have sprung up in such exotic places as Lichtenstein, Vanuatu, and the Netherlands Antilles. Some examples of types of tax haven countries are as follows:

1. Countries with no income taxes, such as Bahamas, Bermuda, and the Cayman Islands.
2. Countries with taxes at low rates, such as the British Virgin Islands.
3. Countries that tax income from domestic sources but exempt income from foreign sources, such as Hong Kong, Liberia and Panama.
4. Countries that allow special privileges: generally their suitability as tax havens is limited.

To take advantage of a tax haven, a corporation would ordinarily set up a subsidiary in the tax haven country through which different forms of income would pass. The goal is to shift income from high-tax to tax haven countries. This is normally accomplished by using the tax haven subsidiary as an intermediary. For example, an Indonesia manufacturer could sell goods directly to a distributor in Germany and concentrate the profits in Indonesia, or it could sell the goods to a tax haven subsidiary at cost and then sell the goods to the German distributor, thus concentrating the profits in the tax haven subsidiary with no income taxes or with tax at low rates.

Every tax haven has advantages, such as having a low or zero rate of tax on all or certain categories of income, and offering a certain amount of banking or commercial secrecy. and disadvantages depending on what you hope to achieve. The 13 indicators identified here for judging a tax haven's potential will help you gauge how each potential tax haven stacks up against your goals. The object, of course, is to find a tax haven with the maximum number of advantages that satisfy your requirements. (1) tax structure (2) political and economic stability (3) exchange controls (4) tax treaties (5) government attitude (6) modern corporation laws (7) simple incorporation procedures and competitive fees (8) communications and transportation (9) banking and professional services (10) English common law (11) secrecy and confidentiality (12) investment incentives and opportunities (13) location

TRANSFER PRICING

According to a new survey by Ernst & Young that transfer pricing is the most important international tax issue that multinational enterprises (MNEs) now face. Transfer pricing involves the price at which transactions between units of multinational companies take place, including the intercompany transfer of goods, property, services, loans, and leases. Transfer Pricing has attracted increasing worldwide attention. The significance of the issue is obvious when we recognize that transfer pricing (1) is conducted on a relatively larger scale internationally than domestically (2) is affected by more variables than are found in a strictly domestic setting (3) varies from company, industry to industry, and country to country, and (4) affects social, economic and political relationships in multinational business entities and sometimes, entire countries

Governments around the world require transfer pricing methods base on the arm's-length principle. That is a multinational 's business in different countries are taxed if they were independent firms operating at arm's-length from each other. The complex calculation of arm's-length prices is less relevant today for global companies because fewer of them operate this way.

An arm's-length price is one that an unrelated party would receive for the same or similar item under identical or similar circumstances. Acceptable arm's-length pricing method include (1) comparable uncontrolled pricing (2) resale pricing (3) cost-plus pricing, and (4) other pricing methods. An emerging consensus among governments views arm's-length pricing as the appropriate standard in calculating profits for tax purposes. However, countries vary in how arm's-length pricing is interpreted and implemented, As a result, it is somewhat fluid concept internationally

Transfer Pricing schemes designed to minimize global taxes often distort the multinational control system. When each subsidiary is evaluated as a separate profit center, such pricing policies can result in misleading performance measures that generally lead to conflicts between subsidiary and enterprise goals.

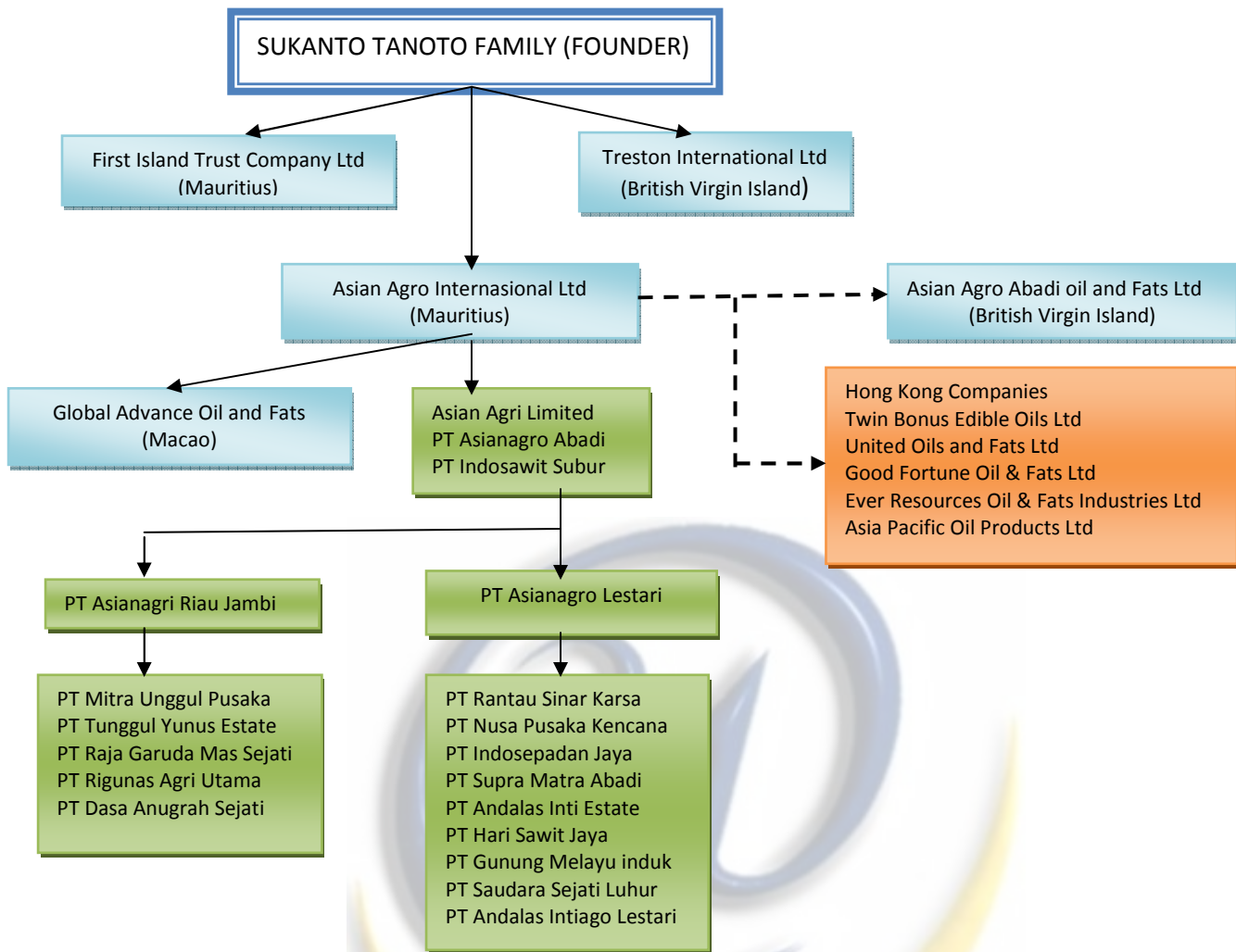
The international transfer pricing system must also attempt to accomplish objectives that are irrelevant in a purely domestic operation These objective include (1) worldwide income tax minimization (2) minimization of worldwide import duties (3) avoidance of financial restrictions, (4) managing currency fluctuations, and (5) winning host country government approval. It is unlikely that a MNC will be able to accomplish all objectives with a single transfer pricing strategy. Priorities usually include the minimization of worldwide income taxes and import duties.

Advance Pricing Agreement (APAs), or they are called an Advance Pricing Arrangement (United Kingdom), and Preconfirmation System (Japan), are a mechanism whereby a multinational and a taxing authority voluntarily negotiate an agreed transfer pricing methodology that is binding on both parties. These agreements reduce or eliminate the risk of a transfer pricing audit, saving time and money for both the multinational and the taxing authority. The agreements are binding for a fixed period of time, for example 3 years in the United State.

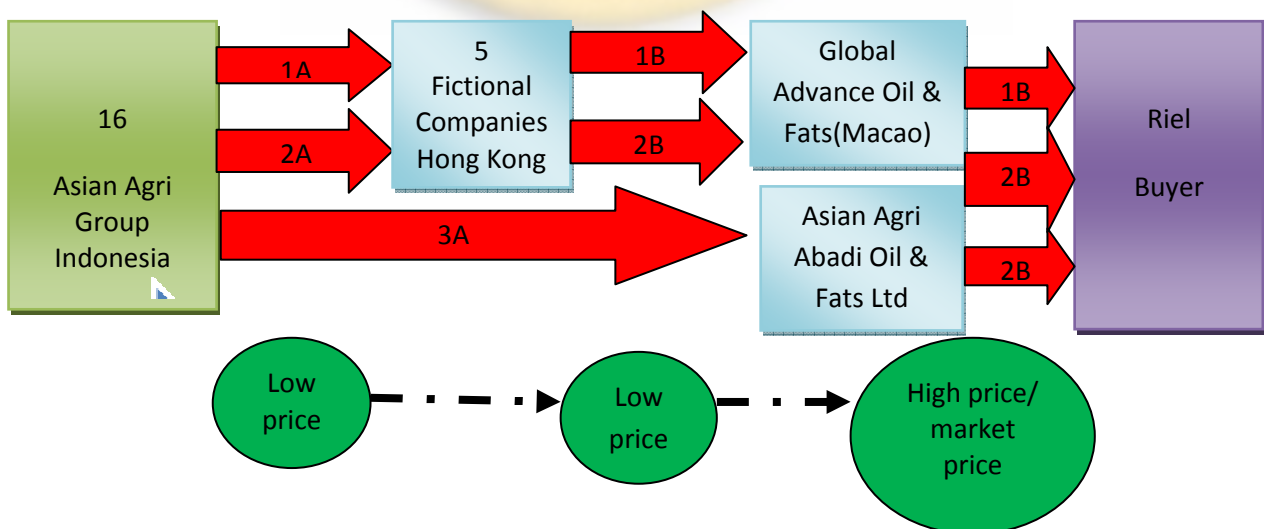
INDONESIA CASES

Asian Agri Organizational Structures for Reducing Tax Liabilities

There are 16 industries in Indonesia that most of these companies produced Crude Palm Oil (CPO) for export and 5 companies in Tax Havens countries as affiliated companies (so-called mailboxes company) to minimize corporate taxes for the group as a whole. A necessary element of such strategy is the prices at which goods and services are transferred between group companies. Profits for the corporate system as a whole can be increased by setting high transfer prices on components shipped from subsidiaries in relatively low tax countries, and low transfer price on component shipped from subsidiaries in relatively high tax countries



Asian Agri Transfer Pricing Strategy



Asian Agri Profit Shifting

The transfer pricing system can be used to shift taxable profits from a country with a high tax rate to a country with a lower tax rate: the result is that after taxes the MNC retain more profits

There are 16 (sixteen) Asian Agri Group Companies in Indonesia, manufactures goods (CPO) and most of the CPO for sale overseas. Finished goods (CPO) are transferred from Asian Agri Group to its wholly owned sales affiliate for overseas sales through 5 (five) so-called mailbox companies in Tax Havens country, using a low markup policy and using a high markup policy for the real buyer. (1A, 2A, 3A, 1B, 2B) The low markup policy results in larger pretax income, income taxes, and net income per unit in the selling country. On the other hand, the high markup policy has the opposite effect, that is, higher taxable income, income taxes, and net profit per unit in the manufacturing country. The affiliate companies in Tax Havens Country are likely represent the manufacturing company, there is no problem of larger pretax income since the tax rate imposes in tax havens country are very low: the result is that after taxes profit the Asian Agri Group retain a big profit

CONCLUSION:

The choice of organizational form for conducting foreign operation is also influenced by country incentives encourage to designed certain types of activities considered beneficial to the national economy. The location of production and distribution systems also offer tax advantages. Thus final sales of goods or services can be channeled through affiliates located in jurisdiction that offer tax shelter or deferral. In these case, parent corporation (Asian Agri Indonesia) ships the product (CPO) directly from 16 (sixteen) factories Asian Agri Group Companies in Indonesia to the European buyer, but also makes a paper sale of the goods to its wholly-owned affiliate as foreign sales corporations (FSCs) in Macao, Mauritius, and British Virgin Island. The payment from the buyer is routed through Hong Kong Companies that arrange how much money will be sent to Asian Agri Indonesia as an income for tax purposes,

In responding to the the problem of shifting of revenues above and also demands of a growing market economy, the resulting increase in the number of taxpayers, and the need to establish the legitimacy of tax collection, from year 2007 up to 2010, our country has been reformed four tax laws, e.g. General Provisions and Tax Procedure Law, Income Tax Law, Value Added Tax and Sales Tax on Luxury Goods Law and Regional Tax Law,

While in relation with the transfer pricing, for a certain companies my country also arranges an Advance Pricing Agreements (APAs) whereby a multinational and our taxing authority voluntarily negotiate an agreed transfer pricing methodology that is binding on both parties.

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