

Offshore Territories and the Problem of Money Laundering

Sheralieva Zilola ¹

Abstract

This article discusses offshore zones and their specific features and the problem of money laundering.

Key words: *offshore countries, offshore company, classic offshore, tax benefits, LLC, black money, money laundering, hawala system.*

Introduction. Offshore countries are on the black list of offshore zones compiled by the Federal Tax Service or countries with a favorable tax regime. Offshore companies legally provide certain tax benefits to business entities and individuals. An offshore company is a company incorporated and operating under the rules and laws of a classic offshore jurisdiction. There are laws that allow foreign investors and entrepreneurs to receive tax and business benefits in almost any country, including large and developed countries. Singapore is not considered offshore - it is midshore, a normal high tax jurisdiction that offers benefits for international businesses under certain circumstances.

Level of study. Fundamental and practical aspects of Money Laundering from foreign scientists Prof. Dr. Brigitte Unger, Will Kenton, James Chen, Somer Anderson, Ryan Eichler.

Methodology. A systematic approach, comparative analysis methods were used in the process of writing the article.

Offshore is a tool that solves various problems. Like any tool, it can be used for legitimate purposes, but some users choose to use it offshore to break the law. Illegal offshore use is punishable and the hunt for such offenders has increased recently. The world's tax administrations are actively cooperating and helping to find refugees and tax evaders. The activities of offshore zones include:

- ✚ to help protect property rights to assets (companies, real estate, shares, etc.);
- ✚ carrying out international activities, including import-export operations, provision of goods or services, etc.;
- ✚ to carry out gambling, insurance or banking activities on the basis of a license.

Offshore companies help to optimize business processes, reduce reporting time, access new customers and reduce the effective tax rate. Later, when these islands became de facto self-governing states, their authorities passed laws that made it attractive for international business companies to register there, with some serious tax breaks being offered. Thus, the phrase "offshore zone" came to refer to zero-tax jurisdictions, and "offshore company" refers to a company registered in such a jurisdiction. However, the concept of "tax breaks" still exists and some countries offer more conditions to foreign entrepreneurs than others. There is no generally accepted classification of offshore zones, but there are several qualities that allow such zones to be divided into classes. These qualities include:

- Tax requirements;
- Reporting requirements;
- Privacy level of personal data.

¹ Master of the 1st stage of the Faculty of Economics of the National University of Uzbekistan



Offshore jurisdiction allows you to reduce the tax burden, simplify accounting and increase the level of privacy of your personal information. Offshore jurisdictions can be divided into four classes based on tax requirements:

1. "Classic" offshores. A key feature found in these jurisdictions is the zero taxes they levy. Corporate tax exemptions are not the only tax benefits that offshore companies offer. Often they do not charge capital gains tax, inheritance tax, global income tax or personal income tax etc. from its residents. However, in any country there is a state duty that is paid instead of taxes. In the past, most offshore zones were not required to maintain financial reports and submit to the authorities, and the confidentiality of information was high. Today, records must be kept and filed in some countries. The privacy of company owners' personal information is still protected, but not as much as before. Some countries have joined the group of countries implementing the automatic exchange of financial information. The biggest disadvantage of such jurisdictions is that they are found on various blacklists. This means that companies registered there face problems opening bank accounts and risk reputation. The following countries can be called "classic" offshore: Seychelles, Nauru, British Virgin Islands and Belize.² In the past, most offshore zones were not required to maintain financial reports and submit to the authorities, and the confidentiality of information was high. Today, records must be kept and filed in some countries. The privacy of company owners' personal information is still protected, but not as much as before. Some countries have joined the group of countries implementing the automatic exchange of financial information. The biggest disadvantage of such jurisdictions is that they are found on various blacklists. This means that companies registered there face problems opening bank accounts and risk reputation. This means that companies registered there face problems opening bank accounts and risk reputation. The following countries can be called "classic" offshore: Seychelles, Nauru, British Virgin Islands and Belize.³

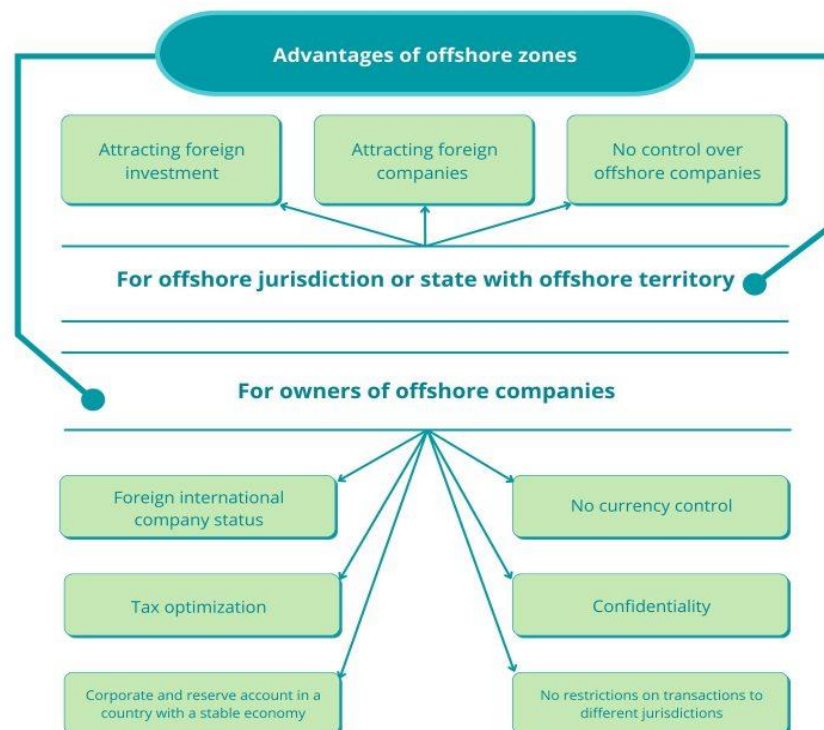


Figure 1. Advantages of offshore zones.

² <https://internationalwealth.info/>. Offshore Islands, Countries, Territories, and Lists 2022.

³ <https://internationalwealth.info/>. Offshore Islands, Countries, Territories, and Lists 2022.



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2. Low tax jurisdictions

The average corporate tax rate worldwide is 22.6%. If a nation-state charges less than half the corporate tax, it can be called a low-tax jurisdiction. For example, corporate tax in Hungary is 9%, and in Cyprus and Ireland it is 12.5%.⁵

3. Jurisdictions with territorial taxation systems

Of particular interest are offshore jurisdictions that use a territorial taxation system. While many countries tax their citizens and legal residents regardless of where in the world they earn income, some nation states only tax income earned within their geographic borders. If a business company registered in such a country earns income abroad, this profit will not be taxed in the country. For example, Hong Kong applies territorial taxation. So, if your Hong Kong-registered company exports goods from China to Russia, the US or Germany, Hong Kong taxes will not be paid because the profits are made outside the jurisdiction. However, Hong Kong greatly values its positive international reputation and this requires constant inspections and annual audits. In addition, it is not so easy to prove that your company should benefit from the 0% tax credit.

4. Onshore jurisdictions with offshore territories (known offshores).

If you are a foreigner and you choose the right territory (state) and the right type of company ownership, you can benefit greatly by setting up a business company there. You can minimize or even avoid corporate tax and keep your information private. Apart from the UK and the US (which is the world's largest offshore zone), other favorable jurisdictions include Malta (where corporate tax is 35% but can be reduced to 5%), Austria, the Netherlands and Liechtenstein. The latter three jurisdictions offer special tax regimes under special conditions.⁶ Switzerland with its cantons can also be included in this group of countries. The difference is that Switzerland is more popular for opening bank accounts there than for registering companies. Proceeds from criminal activities are considered black money. Black money proceeds are generally received in the form of cash from underground economic activities and are therefore not taxed. The receivers of black money try to give it the appearance of legitimacy by hiding it, spending it only in the shadow economy or laundering it. In its simplest form, black money is money that is not taxed to the government. Suppose a store accepts cash for its merchandise and does not issue checks to customers. This shop deals in black money as it does not pay tax on unrecorded transactions. As another example, consider a property buyer who purchases \$200,000 of land. If the buyer reports only \$50,000 on the books and pays \$150,000 under the table, then there is a black money transaction of \$150,000. The sellers in both examples made money from legitimate sources but avoided taxes. The most common source of black money is the black market or underground economy. Black market activities can include the sale of illicit drugs, shootings, terrorism, and human trafficking. Black market activity also includes less serious crimes such as the sale of counterfeit goods, stolen credit cards, or pirated versions of copyrighted material. The share of a country's income due to black money affects the country's economic growth. Black money causes financial leakages as untaxed income leads to loss of revenue for the government. In addition, these funds rarely enter the banking system. As a result, it may become difficult for legally operating small businesses and entrepreneurs to get a loan. Moreover, black money leads to neglect of the country's financial health. Calculating the amount of black money in any economy is extremely difficult. This is not surprising given that actors in the shadow economy have strong incentives to conceal their activities. These unreported earnings cannot be included in a

⁴ <https://internationalwealth.info/>. Offshore Islands, Countries, Territories, and Lists 2022.

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country's gross national product (GNP) or gross domestic product (GDP). Thus, the government's assumptions about savings, consumption, and other macroeconomic variables will be inaccurate. These uncertainties adversely affect planning and policy making. Black money is most profitable in societies with the best laws. In the Soviet Union, for example, many ordinary market economic transactions were illegal. People turned to the underground economy to overcome shortages and obtain prohibited goods. In many other cases, regimes have imposed price controls that make goods unobtainable or sales taxes that make them unaffordable. Black money has provided a way to reduce losses. Most black money holders try to convert the money into legitimate money also known as white money. There are several ways to do this. Anti-money laundering penalties are often severe, so legitimate businesses must be careful not to accidentally become involved in it. Money laundering can be done using the hawala transaction system.⁷ The Hawala system is an informal and inexpensive way to transfer money from one region to another, without any real money movement and without the use of banks, it works on codes and contacts, and no paperwork or disclosure is required. If a money launderer in the US decides to send \$20,000 to a recipient in India through a hawala seller, the agreed exchange rate is set at a much higher rate than the official rate. Money laundering is the illegal process of making "dirty" money look legitimate instead of being obtained through illegal means. Criminals use various methods of money laundering to make ill-gotten funds look clean. Online banking and cryptocurrencies have made it easier for criminals to transfer and withdraw money without being detected. Preventing money laundering has become an international effort and is now among the targets of terrorist financing. The financial sector also has its own stringent anti-money laundering (AML) measures. Legalization of the proceeds of crime is very important for criminal organizations that want to make effective use of illegally obtained money. Dealing with large amounts of illegal cash is inefficient and dangerous. Criminals need a way to deposit money into legitimate financial institutions, but they can only do so if it appears to have come from legitimate sources. The money laundering process typically involves three steps: placement, layering, and integration. Colocation smuggles "dirty money" into the legitimate financial system.

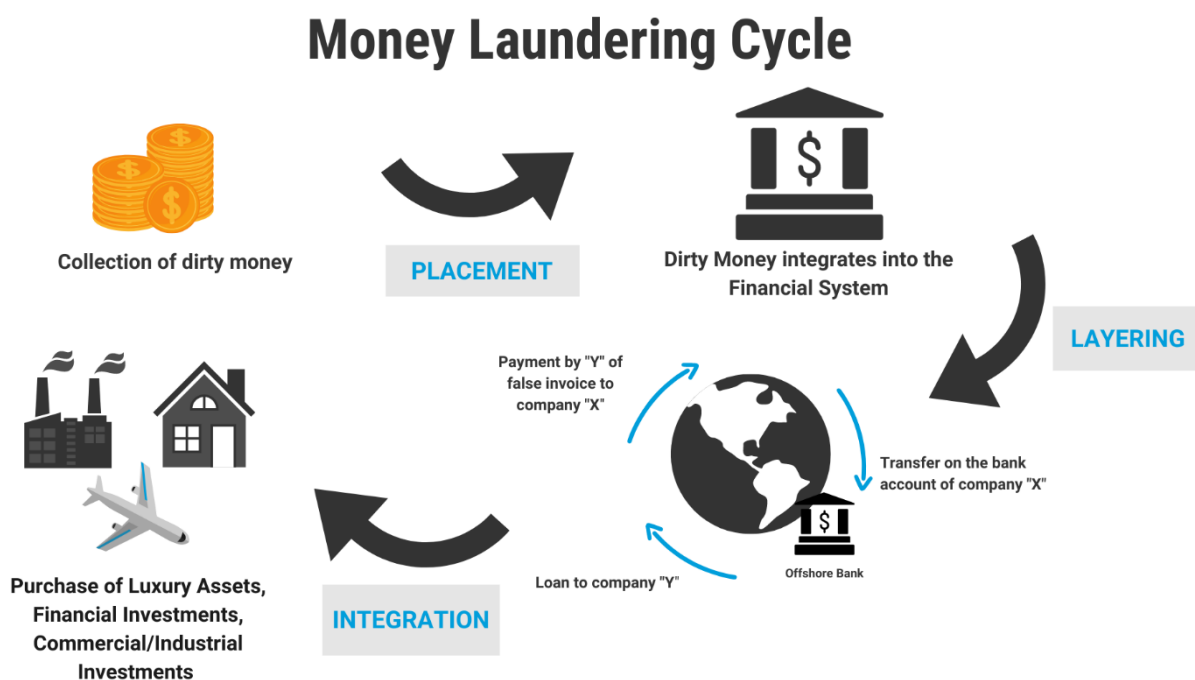


Figure 2. Money laundering cycle.

⁷ Will Kenton "What Is Black Money? Meaning, Definition, and Criticism" October 30, 2020



Layering hides the source of the money through a series of transactions and accounting tricks. In the final stage, integration, the laundered money is now withdrawn from the legitimate account and used for whatever purposes the criminals put it to. There are many methods of money laundering, from simple to complex. One of the most common methods is to use a legitimate, cash-based business owned by a criminal organization.

Conclusion. Offshore zones allow you to reduce the tax burden, simplify accounting and increase the level of privacy of your personal information. Proceeds from criminal activities are considered black money. Black money proceeds are generally received in the form of cash from underground economic activities and are therefore not taxed. The receivers of black money try to give it the appearance of legitimacy by hiding it, spending it only in the shadow economy or laundering it. In its simplest form, black money is money that is not paid to the government, and criminals use offshore zones to launder black money.

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