OFFSHORE: LEGAL OR ILLEGAL?*

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It has been an ever growing debate over the existence and the legality of offshore companies since their appearances in the early 1800s. In the 21st century, voices against the existence of the offshore phenomenon got even louder as the financial crisis bursted out in 2008 and hurt – and in some places it is probably still hurting – the interests of national economies. Offshore is not an easy terminology to define, however, we may identify two very distinct scenarios in this respect. In the first case, a company that is incorporated in a tax haven is doing almost the entirety of its business activities outside the country of incorporation and takes the profit back there to pay its dues by the probably very favorable tax rates. In the other scenario, the company outsources most of its production into a country that is different than the one in which the company was originally incorporated. In the first case, we experience a clear agenda of tax evasion, while in the second case, there may be even more serious consequences of the offshore activities for the economy and society of the home country (e.g. the offshore company is not conducting its activities by hiring domestic workforce, it does not feel the need to support the community it operates in etc.). For the purposes of this study, we consider offshore as a definition determined by the first scenario.

The majority of the world are in a constant combat against the phenomenon of offshore, and still, these combined efforts are not sufficient to stop the 'disease' from spreading. Here, we do not want to go into a deeper economic analysis on certain benefits of the offshore model, instead, we take it as a generally accepted statement that offshores are hurting national economic interests in the host countries, most importantly public interests as they consider the country where they conduct their activities playgrounds and they do not support it by paying their public burdens there. This combined effort in many jurisdictions of the world often use sanctions and prohibitions that are public administrative, criminal and tax related in nature, trying to make national laws less favorable to offshore activities. In this agenda, many forget about the importance of private law, especially the role of company laws that may be either favorable or disadvantageous to offshore activities in the host country. Company laws can also effectively fight against offshores tying companies incorporated in a country to that home country. A notable example to this policy is the somewhat hypocritical approach of Hungary prior to 2005. The old Company Tax Act[2] in Hungary provided a definition to 'companies conducting business activities abroad' and established multiple requirements for these entities. While the old Hungarian law certainly allowed the establishment of offshore companies in the country, this was definitely not an encouragement if we take a closer look at the regulatory details. First

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[2] Act LXXXI of 1996 on the company tax and divident tax.

of all, the law imposed nationality requirements for the employees and the staff members. These companies conducting business activities abroad had to prove that the majority of their employees, managers and supervisory board members were Hungarian nationals, and they also had to register a Hungarian lawyer or law firm and an accountant. Conducting the majority or all the business outside the country of incorporation following these requirements was extremely difficult if not impossible to those in the production and manufacturing business as moving and accommodating the workers from the home country to the country of activity probably made the costs irrational and detoured many from considering Hungary as their place of incorporation. In the financial and some service sectors, however, it might have worked, and it could certainly still be a feasible option if the company is willing to utilize the achievements of telecommunication (e-sales). The nationality requirement, however, was not sufficient and, therefore, could not be continued after Hungary had joined the European Union as the Union-wide non-discrimination clause did not tolerate such restrictions. We have to point out that this now historical regulatory approach only works if the home country is willing to cooperate in the restriction of offshores, or, if the country of incorporation would like to prohibit its own companies to go offshore and use their favorable taxation system for such purposes. Unfortunately, it is not how famous tax havens treat the phenomenon of offshore, so this model does not seem to be a viable option to company law in the combat against offshores.

Another interesting concept to keep offshores out is when company laws stick to the real seat theory in order to decide over the nationality of a company. In private international law, two theories are competing to each other. The incorporation theory emphasizes the importance of incorporation, therefore, the governing law is determined by the place of registration, no matter where the company is conducting business activity or whether it does any activity in the country of incorporation. On the other hand, the real seat theory determines the applicable law by reference to the country in which the company has its actual real seat, head office or central administration. The world is quite divided on this matter, and even EU member states do not seem to have an agreement on this. The incorporation theory certainly encourages pseudo-foreign companies (e.g. offshores), while the real seat theory may run into difficulties in determining what real seat truly means, and it may also be anti-competitive. The United States, Canada, the United Kingdom, Austria, Sweden and China are some important players following the incorporation concept. Germany, France, Turkey or Spain are true believers of the real seat theory. The real seat theory may serve as a safeguard against forum shopping since the company can only move its central business activity if it is willing to change its legal status too. While under the umbrella of the incorporation theory, operating offshores does not run into obstacles in terms of the institutions of company law, the real seat theory may be a true blockage. If the country of incorporation (home country) and the country of real seat (host country) follow different concepts, they may easily claim simultaneous legal governance over the very same company at the very same time. In tax law, treaties for the avoidance of double taxation may show some relief, however, company law still causes turbulence in the operation of offshore companies (e.g. shareholders claiming safeguards against the management, stricter rules and requirements for managers and their liability,

favorable and less favorable capital requirements, supervisory tools over the operation of the company etc.). The European Union tried to solve this chaos generated by the various company law theories through the Recognition Convention in 1968, however, it never entered into force.[3] As the European Court of Justice emphasizes the somewhat restricted concept on the freedom of establishment for companies[4], it certainly encourages mutual recognition making this debate almost meaningless if we purely focus on company law issues and inter-EU offshoring.[5]

Many think that the idea of offshore is solely governed by the existence of tax havens and favorable taxation systems all over the world. There may be, however, another aspect of offshoring, the so-called jurisdictional offshoring. If we take the European Union as an example, we can easily see how jurisdictional shopping gets more and more popular due to lack of a unified company law in the Union. Under the freedom of establishment principle, companies incorporated in any member state of the EU enjoy non-discrimination in other member states and they must be treated as domestic companies. The Treaty on the Functioning of the European Union (TFEU) grants for the companies to do business in another member state. The restriction-based reading of the Treaty, however, may raise the question whether a member state has a right to enact barriers when a domestically incorporated company wants to leave the state.[6] An even more interesting angle of this problem was under scrutiny in the infamous Inspire Art Case.[7] A company incorporated under UK law having a sole director with a domicile in the Hague opened a branch in the Netherlands for tax considerations. Back then, Dutch law had a regulatory framework applicable to 'formally foreign companies'. That law established special rules for the responsibility of the managers, certain minimum capital requirements, and a specification in the company register that the firm is formally foreign. The 'formally foreign' label alone was found discriminatory by the European Court of Justice as it could have easily discouraged costumers and potential business partners. The Dutch law wanted to prevent jurisdictional offshoring through a label in the firm's name showing that the company does not consider itself a domestic company and does not pay its public burdens in the country it gathers the majority or the entirety of its profit.

The debate over the legality of offshores are complex, and those arguing against the beneficial existence of offshoring should take into consideration that a complex problem needs complex, multi-area treatment. Tax law and public administrative law cannot be effective in the combat against offshores if company law – the source of the problem in a legal sense – is not considered as an important regulatory instrument in this battle. The EU's anti-discriminatory practice on taxation cannot eliminate the phenomenon of offshore alone. Over the past decade, jurisdictional offshoring also

[3] Jacobsen, Christen Boye: An introduction to modern EU company law, RGSL Working Papers no. 28, Riga, 2005, available at: http://www.rgsl.edu.lv/images/stories/publications/Jacobsen_final.pdf (10 July 2016).
[4] Daily Mail case C-81/87, Cartesio case C-210/06, Vale case C-378/10.
[5] Überseering case C-208/00, Inspire Art case C-167/01.
[6] Centros case C-212/97.
[7] Inspire Art case C-167-01.

became a problem, hurting the competitiveness of certain member states. There is no doubt that a unified company law could easily eliminate this problem from the continent, however, it is a somewhat utopistic idea now, and it does not seem to become a reality soon. If Europe would like to make more effective steps against external offshoring, it first has to settle the questions of the two competing theories over the governing company laws (incorporation and real seat), then it should move toward the detailed rules of taxation and public administration laws.