

# Closing the Floodgates

Collecting tax to pay for development



Commissioned by  
The Norwegian Ministry of  
Foreign Affairs





# Contents

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<b>Abbreviations.....</b>	<b>4</b>
<b>Foreword - Closing the Floodgates .....</b>	<b>5</b>
<b>Recommendations.....</b>	<b>7</b>
<b>Section 1 - The Flood of Lost Taxation.....</b>	<b>12</b>
Chapter 1 - Taxation and Development.....	12
Chapter 2 - The Floodgates are Open.....	15
Chapter 3 - The Scale of the Flooding.....	36
<b>Section 2 - How the Floodgates are Opened .....</b>	<b>42</b>
Chapter 4 - How Companies Reduce Their Tax Bills.....	42
Chapter 5 - How Individuals Reduce Their Tax Bills.....	57
Chapter 6 - How Governments Don't Help Themselves.....	64
Chapter 7 - The Role of Tax Intermediaries.....	72
Chapter 8 - The Role of Tax Havens.....	81
<b>Section 3 - Closing the floodgates.....</b>	<b>91</b>
Chapter 9 - The Next Steps .....	91
Chapter 10 - Tackling Harmful Tax Practices .....	115
Chapter 11 - Capital Flight and Tax Avoidance Through Abnormal Pricing in International Trade - the issue and solutions .....	118
<b>Bibliography .....</b>	<b>123</b>
<b>Appendices .....</b>	<b>124</b>
1. - The Millennium Development Goals .....	124
2. - Corporate tax rates .....	127
3. - The world's tax havens and the firms that operate in them .....	128
4. - Mirror, Mirror on the Wall, Who's the Most Corrupt of All? .....	132
5. - Jersey passes law allowing 'sham' trusts for use by tax evaders .....	148
<b>About the authors .....</b>	<b>151</b>
<b>About the Tax Justice Network .....</b>	<b>152</b>

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This paper represents the views of the authors and may not reflect the views of the Norwegian Ministry of Foreign Affairs (MFA).

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Alex Cobham provided invaluable editorial input and comment throughout the production of this report, for which thanks are offered.

The authors have asserted their moral rights to the sections of this report for which they are responsible.

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# Abbreviations

CPI	Corruption Perceptions Index
CTJ	Citizens for Tax Justice
ECOSOC	United Nations Economic and Social Council
EITI	Extractive Industries Transparency Initiative
EPZ	Export processing zone
EU	European Union
EUSTD	European Union Savings Tax Directive
FDI	Foreign direct investment
GANTIP	General Anti-Avoidance Principle
GDP	Gross Domestic Product
GST	General Sales Tax
HMRC	Her Majesty's Revenue & Customs
IASB	International Accounting Standards Board
IBC	International business corporation
IFI	International financial institution (viz World Bank)
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IRS	Inland Revenue Service (United States)
LLC	Limited liability company
LLP	Limited liability partnership
MDG	Millennium Development Goals
MNC	Multinational corporation
OECD	Organisation for Economic Cooperation and Development
PCC	Protected cell company
PWYP	Publish What You Pay coalition
ROSCS	Reviews of Standards and Codes
SIE	Small island economy
TI	Transparency International
TJN	Tax Justice Network
TNC	Transnational corporation (also called an MNC)
UN	United Nations
UNCAC	United Nations Convention Against Corruption
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax
WTO	World Trade Organisation

# Foreword

## Closing the Floodgates

For those concerned about persistent poverty in a world of plenty, the Millennium Development Goals were amongst the most important statements of hope ever written<sup>1</sup>.

This report is submitted within the context of those Goals, and builds on the work of the International Conference on Financing for Development (Monterrey, Mexico, 2002) which called upon developing countries to mobilize their domestic resources for development. The authors also recognise the important contributions made in the Landau Report<sup>2</sup> commissioned by President Jacques Chirac and the 'Lula Report'<sup>3</sup>, '*Action against Hunger and Poverty*.' As all of these reports have made amply clear, urgent steps need to be taken to prevent the flood of domestic financial resources out of the poorer countries and to protect already impoverished states from abusive tax practices. These actions are a prerequisite to ensuring that the Millennium Project does not become a wasted opportunity.

As this report demonstrates, the scale of capital flight and tax evasion is more than sufficient to finance the

achievement of the Millennium Development Goals. More research is needed to accurately quantify the sums lost to individual countries, but a review of the various estimates suggests that in aggregate it runs to many hundreds of billions of US dollars a year. Whilst not all of the losses will be recoverable, even partial recovery could significantly increase the resources available for development. We therefore propose that placing capital flight and tax evasion on the Leading Group's agenda would be a major step towards creating an enabling environment for tackling poverty and financing development.

In preparing this report we have purposefully set out to provide (a) the most comprehensive review ever published of the nature and scale of the problems, and (b) a series of recommendations for how governments and international agencies might tackle them. The report is structured in three sections:

Section One deals with the issues as they relate to development, and assesses the damage caused by the flood of capital flight and lost taxation revenues.

Section Two, consisting of five chapters, considers how corporations and individuals avoid and evade tax; how governments have facilitated abusive practices, or have not taken sufficiently robust steps to prevent such abuse; the role of the tax intermediary professions (lawyers, bankers, accountants, other tax

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<sup>1</sup> See appendix 1.

<sup>2</sup> [http://www.conservaionfinance.org/Documents/CF\\_related\\_papers/Landau\\_commission\\_article2.pdf](http://www.conservaionfinance.org/Documents/CF_related_papers/Landau_commission_article2.pdf) accessed 26-1-07

<sup>3</sup> [http://www.cttcampaigns.info/documents/brasil/Report-final\\_per\\_cent20version.pdf](http://www.cttcampaigns.info/documents/brasil/Report-final_per_cent20version.pdf) accessed 26-1-07

agents and financial services providers); and the role of the offshore tax havens that provide the mechanisms, often in combination, to facilitate capital flight and loss of taxation revenue.

Finally, in Section Three we propose a series of measures for tackling the problems and closing the floodgates through which the financial resources of developing countries are draining away.

We recognise that tax policy can be complex, particularly in an international context. We have therefore sought to do two things in this report: firstly to demystify the issues, and secondly, to demonstrate that much can be done immediately to diminish capital flight and tax evasion. Crucially, we show that the normal assumption that this requires multilateral agreement before effective progress can be made is simply not the case.

As our report makes clear, tackling the flood of capital flight and abusive tax practices would probably yield sufficient revenue to accomplish the Millennium Development Goals. Beyond that the additional tax revenues could also:

- Provide the necessary resources for developing countries to free themselves from aid dependence;
- Strengthen the relationship of democratic accountability between citizens and state to enhance standards of governance;
- Provide opportunities for progressive cuts in tax rates in many countries as the tax base is broadened to include sums now evaded or avoided;
- Provide opportunity for simplification of tax law in many countries, thereby reducing the burden of tax administration for many people.

And there are other significant gains to be had from adopting a tax justice agenda, including:

- Reduced opportunities for crime, including crime related to corruption of all sorts;
- Exposure of the 'secrecy spaces' provided by tax havens will strengthen economies because enhanced trade and investment transparency will lower risk and reduce costs;
- Action against aggressive tax avoidance will reduce incentives for corruption and increase incentives for genuine entrepreneurial activity undertaken to increase human well being rather than create short term increases in post-tax profits.

We regard it as crucial that corrupt tax practices are tackled in a comprehensive manner in order to restore public confidence in the ability of democratic forms of government to protect the rule of law and promote the equity of our tax systems.

Taken in combination, our proposals could go a long way towards achievement of the Millennium Development Goals; towards tackling the harmful inequalities within and between countries; and towards restoring the credibility of the market system itself.

A handwritten signature in blue ink that reads "John Christensen".

John Christensen  
Director  
TJN International Secretariat  
London  
1<sup>st</sup> February 2007

## Recommendations

The attached report is longer than those customarily presented to conferences, but is in fact itself a summary of an enormous body of material that documents the problems that are faced in collecting taxation revenues throughout the world. The issues involved are too important to be reduced to a page or two. We can do no more than ask that you read the report we have written.

There are several good reasons for making this request. The first is that it is clear from Chapter 3 that addressing the issue of evaded and avoided taxation revenues as a means to finance development might yield returns that will exceed sums raised using any other approach. When the losses from these activities run to hundreds of billions of US dollars a year even relatively minor improvements in collection rates would provide enormous sums to finance the Millennium Development Goals.

The second point to note is that this is not an issue for developing countries alone. A recurring theme of this report is that the problems faced are not 'elsewhere'; they are located in every state around the world, whether it be a developing, transitional or developed country and, additionally, whether it is a tax haven or not. The reason is straightforward. Nothing less than a change in our attitude towards taxation and corruption is required if this initiative is to succeed. That change starts at a personal level, and can extend to embrace the globe. On the way it will require changed accounting, law, regulation and professional conduct, all of which are issues that this report addresses.

It is for this reason that the recommendations made in this report are

comprehensive. This problem needs to be tackled through a variety of measures, and to suggest there is either a 'magic bullet' that solves it or that one solution will suit all countries is unrealistic and wrong. This explains why we have split our recommendations into groups and have avoided suggesting priorities, since these will need to be determined locally in many instances.

There are, however, four exceptions which we would like to draw particular attention to. The first is that the International Accounting Standards Board (IASB)<sup>4</sup> is currently consulting on a paper presented to it by the Publish What You Pay coalition, which it prepared in association with the Tax Justice Network. The objectives of that paper are explained in section 7 of chapter 9 of this report. We are of the opinion that there is no action that could be more useful at this moment than each country affiliated to the Leading Group making clear to the IASB that they support the principles inherent in that submission, which calls for transparent accounting by multinational companies (MNCs) on a genuine country-by-country basis for every country in which they operate, without exception. This would benefit a wide range of stakeholder groups, but most particularly those governments in the developing world who have enormous difficulty in holding MNCs to account for the tax that they owe them. In addition, it will assist those supporting wider accountability by governments in those same countries for the funds entrusted to them, whether they be derived from

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<http://www.iasb.org/News/Press+Releases/IASB+issues+convergence+standard+on+segment+reporting.htm> accessed 31-1-07



taxation or other sources. That is our first specific request.

Our second request is that whilst we know the scale of the problem we are facing not everyone is persuaded of its significance, or that benefit may be obtained from the practical recommendations we make for tackling this issue. We believe that hearts and minds have to won to this cause, which is best done through clear reasoned argument backed by facts and research. This report is a contribution to that process, but much more needs to be done. That is why the research agenda which makes up the fourth part of our recommendations is so important, and should not be overlooked. It is a scandal that funding for research into tax evasion, offshore activities and abusive tax practices is almost impossible to secure, even in the world's universities. Contrast this with the massive funding available to those who promote tax competition and offshore activities for both research and public advocacy. Much greater resource needs to be secured to research these issues and to promote the research findings and recommendations.

Thirdly, as is widely acknowledged, trade mispricing is one of the most common mechanisms used to facilitate capital flight, tax evasion and tax avoidance. In chapter 11 Simon Pak succinctly summarises both his work in quantifying this problem, and a mechanism for tackling it. His method is transferable and most countries in the world will have the data to create the system for identifying likely trade pricing abuses at their ports and airports as it happens. If ever proof were needed that real action can be taken on this issue, this is it. In addition, this is an area where both data and expertise can be transferred from the developed to the developing world to help countries tackle this issue world-wide.

Finally, and as David Spencer highlights in chapter 10, there is a need for countries to work together on this issue. To date the international initiative on harmful tax practices has been led by the OECD, and there is no doubt that they have the greatest expertise on all these matters. The OECD is not, however, open to membership by all and as the example from Chile in chapter 8 shows, its members obtain preferential treatment when compared with developing countries. As such, valuable as its role has been the OECD needs to now lend its expertise to a wider grouping of nations if the dual objective of tackling harmful tax practices and raising money for development is to be achieved.

We draw particular attention to these issues, but in doing so we do not want to downgrade our further recommendations, all of which would progressively assist in tackling the roots of the problems. In summary these recommendations are:

### **Recommendations that may be adopted unilaterally at a domestic level**

1. Use the language of tax justice: tax is a 'good thing', but that is not always clear even in the case of many government pronouncements;
2. Redefine corruption to include the supply of 'corruption services' that enable those seeking to evade and avoid tax and to arrange capital flight both onshore and offshore;
3. Put transparency onto the domestic agenda by requiring open disclosure of corporate information and the abolition of 'secrecy spaces' in domestic economies;
4. Remove tax haven and harmful tax practices from the domestic tax and regulatory agenda, this being a major challenge for some of the principle



international financial centres such as the UK, the USA and the Netherlands;

5. Require disclosure of all innovative tax planning by commercial enterprises before such schemes are put into operation;
6. Require companies to disclose their tax accounting to taxation authorities thus revealing what planning they are undertaking;
7. Support the call to the International Accounting Standards Board for an International Financial Reporting Standard requiring country-by-country reporting of trading activities and tax paid by multinational corporations;
8. Protect professional tax intermediaries seeking to promote tax compliance by their clients from legal challenge because they have failed to minimise a client's tax liability by using aggressive tax avoidance techniques;
9. Encourage the creation of codes of conduct for the management of domestic taxation to which the government, tax intermediaries and taxpayers can subscribe as indication of a commitment to tax compliance;
10. Introduce a general anti-avoidance principle (GANTIP) into taxation law to ensure that those seeking to abuse the spirit of taxation law whilst complying with its letter are denied the benefit they seek from such abusive behaviour;
11. Introduce an equitable basis for the interpretation of tax law so that current injustices resulting from the use of a legal basis of taxation law in many countries of the world are eliminated;
12. Ensure that governments demonstrate a commitment to transparency by producing clear, comprehensive and comprehensible accounts of their activities. These accounts should be published on a timely and consistent basis, and should be subject to audit, preferably by a government funded but independently managed agency;
13. Governments should estimate the size of their 'tax gaps' on a regular basis and have a published strategy for reducing them;
14. Redefine the residence basis for individuals so that the remittance basis of tax abused by some is no longer available. Also redefine the residence basis for both corporations and trusts so that those linked in any way with a person resident in a country are assumed resident in that country unless contrary evidence can be supplied by the taxpayer.
15. Banks should be required to disclose the ownership of all foreign entities to which they supply services so that this information might be exchanged with the countries in question.
16. Sanctions should be imposed on tax havens that do not actively cooperate on information exchange including the denial of tax credits for tax paid in those territories and the imposition of withholding taxes on payments made to them;
17. Sequester funds that have been secured by either tax evasion or capital flight transactions as is allowed under money laundering regulations throughout most of the world, and require professional intermediaries to report on all transactions where there is suspicion that tax evasion is a likely outcome;
18. Increase the resources available to tax departments to do their work since the additional yield derived from this investment is always significant at current levels of spending.

19. Develop a trade pricing matrix for each country and make use of it at all ports and airports as goods are presented for checking by tax or other authorities, thus limiting the prospect of capital flight and tax evasion through trade pricing abuse.

### **Recommendations for action at an international level**

1. Put strong pressure on UN ECOSOC to address the issues covered by this report, and promote the formation of a World Tax Authority charged with effectively tackling harmful tax practices in association with the need to raise finance for development;
2. Require the IMF to enhance its Reviews of Standards and Codes (ROSCs) to determine which countries are willing to over-rule banking secrecy in cases of suspected tax fraud; which countries and territories actually hold the data required to answer enquiries from other states; and which countries effectively exchange such information in practice;
3. Use OECD and IMF data to create a new list of states unwilling to cooperate to eliminate harmful tax practices.

### **Provision of direct assistance to developing countries**

This might include:

1. Training of tax officials in developing countries including the payment of salaries sufficient to make corruption or private sector poaching less attractive as options;
2. Provision of appropriate IT systems to developing country tax authorities;

3. Development of locally appropriate accounting systems to enhance tax declaration. These may be quite different from those used in developed countries;
4. Designing taxes suited to local circumstances. This might require abandonment of the current IMF conditionality that has required the abandonment of trade tariffs and the promotion of the idea that VAT and other indirect taxes are the solution to all taxation problems when it is apparent from experience on the ground that this is not the case;
5. Support for identifying financial crime;
6. Assistance for initiatives such as the Extractive Industries Transparency Initiative<sup>5</sup>, and their expansion to all sectors of the economy;
7. Technical support with developing taxation measures to mitigate the effects of tax avoidance and evasion;
8. Practical assistance in the supply of information where trade mispricing is believed to have taken place at cost to the country in question;
9. The supply of similar information on an automatic basis, i.e. without the need for request, where it is believed that capital flight is taking place;
10. Development of a multilateral automatic information exchange regime between all countries and tax haven territories (i.e. widening and deepening the work of the OECD Fiscal Affairs Department).

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<sup>5</sup> See <http://www.eitransparency.org/section/about/eiti> accessed 28-1-07

## Promoting research

Research is the key driver of our agenda. We highlight the following priorities:

1. The volume and origin of funds held offshore;
2. Capital flight flows;
3. The origin and target destination of foreign direct investment;
4. What is happening in the tax havens;
5. The extent to which information sharing is taking place;
6. The cost that offshore and other tax planning activities impose on governments;
7. The size of the tax gap - nationally, regionally and globally;
8. The structure of the world's major corporations and the degree to which their decisions are tax driven;
9. The real role of the tax intermediaries and their professional bodies in promoting tax avoidance, and what can be done about it;
10. The impact of the tax losses arising from offshore and other tax planning both on income distribution per head and also on distribution by gender and between ethnic and race groups;
11. The impact of tax planning on trade and the loss of welfare that might result from the distortions that tax planning and tax driven corporate structures add into the trade mechanisms of the world.
12. The economic impact of trade mispricing;
13. The role of tax competition in development and the potential costs it imposes on developing countries;

In addition research is required to identify effective measures to tackle abusive tax practices. This might include work on the following:

1. Mechanisms for promoting automatic information exchange for individuals, trusts and bodies created by statute law;
2. Drafting a Code of Conduct for tax professionals;
3. Practical mechanisms to prevent trade mis-pricing, such as those Simon Pak refers to in chapter 11;
4. Alternatives to the outmoded 'arm's length principle' basis for international corporate taxation;
5. Methods of accounting for governments which might communicate key information to taxpayers to induce greater tax compliance;
6. Appropriate accounting systems for use in developing and other countries which might promote tax compliance;
7. Ways in which tax codes might be simplified whilst broadening the taxation base;
8. Means of successfully introducing general anti-avoidance principles into taxation law;
9. The possibility of creating a World Tax Authority and what powers it might need to regulate this sector;
10. Ways in which taxes might be charged on MNCs on a global basis.

# Section 1

## The Flood of Lost Taxation

### Chapter 1

## Taxation and development

*Domestic revenue mobilisation is key to sustainable development finance - only self-sufficiency will allow the development of fully-functioning states with flourishing systems of political representation and economies reflecting societies' expressed preferences in regard to, for example, inequality.<sup>6</sup>*

This idea summarises the intent of this report.

#### The role of taxation

Taxes are used to:

- Provide public funds;
- Redistribute income to reduce poverty and inequality. Progressive forms of taxation<sup>7</sup>, are one of the

main means by which wealth is redistributed in any society;

- 'Reprice' goods and services to ensure that all social costs of production and consumption are reflected in the market price;
- Strengthen and protect channels of political representation;<sup>8</sup>
- Provide a tool for the management of an economy, usually in combination with government borrowing<sup>9</sup>.

In short, the sustainability of any modern society and economy requires the state to have a well functioning taxation system to both fund the physical and social infrastructure essential to economic welfare and development and to provide stability and security.

#### How tax flows out of economies

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<sup>6</sup> Quoted from Cobham, A. *Tax Evasion, Tax Avoidance and Development Finance*, Working Paper 129, Queen Elizabeth House, University of Oxford, 2005

<sup>7</sup> A tax system where as income rises the amount of tax paid increases in proportion to income as well as in absolute amount i.e. the percentage tax rate increases as the income rises.

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<sup>8</sup> Analysis based on Cobham, A. 2007 *The tax consensus has failed* presented to TJN conference, Nairobi, Kenya, January 2007

<sup>9</sup> See [http://en.wikipedia.org/wiki/Fiscal\\_policy](http://en.wikipedia.org/wiki/Fiscal_policy) accessed 29-1-07 for a discussion of fiscal policy.

It has been suggested that tax flows out of economies in five ways<sup>10</sup>:

1. Due to the existence of the shadow economy which acts as a conduit for capital flight and enables tax evasion;
2. Due to tax not paid on income received or on assets held offshore;
3. Due to MNCs shifting the location in which profits are recorded (i.e. through trade mispricing in its various forms);
4. Due to the pressure of tax competition;
5. Due to tax due not being paid for a variety of reasons.

## Tax and development

The role of the state in the provision of protection, infrastructure and basic services is critical to creating an enabling environment for sustained development. This is especially the case in developing countries, where the higher risk involved in investment, the lack of a capital-rich private sector, and high levels of extreme poverty, create problems unknown in industrialised countries. At its most basic level the inability of developing countries to provide basic health services is seen daily in the loss of lives from preventable diseases.

In our opinion the whole range of issues referred to in the MDGs<sup>11</sup> cannot be tackled unless developing countries secure their own tax revenues. This will free them from aid dependence in the supply of these services. Success in this objective would help countries determine their own futures and chart their own

route out of poverty. That is our primary objective.

Securing the revenues might at the same time create the political accountability that is the other essential component in this process. This is our second objective.

## Common problems

Some of the problems facing tax authorities are common across the world. In particular tax evasion is always an issue, as is tax avoidance. Both issues are addressed in this report: in particular approaches to tax management and the mechanisms used by companies and individuals are explored in chapters 3 and 4. The problems that many governments create for themselves in tackling these issues are explored in chapter 6, whilst the role of tax intermediaries and tax haven states in exploiting these situations are explored in chapters 7 and 8.

Issues addressed in those chapters are not repeated in detail here. That does not mean that developing countries do not face these challenges. Where these issues have a particular development dimension this will be highlighted. The significance of the matters referred to in those chapters is that all states need to address them. That is one of the key messages of this report. The flood of lost tax money does not happen 'elsewhere', whether that be in the tax havens or in developing countries. For every country it starts in their domestic tax system. This is a key issue all governments and tax administrations have in common.

Crucially, however, some of these issues are of greater concern in developing countries, and they have problems all of their own.

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<sup>10</sup> Cobham, A. (2007) *ibid*

<sup>11</sup> See appendix 1

## Tax problems in developing countries

The key tax issues faced by developing countries are:

1. The scale and extent of their shadow economy;
2. Capital flight;
3. The dependence of many such countries on export earnings from mineral and commodity exports conducted by MNCs, and which are prone to trade mispricing;

4. The particular impact of tax planning;
5. The impact of tax competition
6. Administration issues including:
  - a. Corruption and its impact;
  - b. Weak tax administrations;
  - c. The lack of accountability of governments;

These issues form the basis of the following chapter.

## Chapter 2

# The Floodgates Are Open

## Tax problems in developing countries

### The scale and extent of the shadow economy

Most developing countries have a large informal economy which is not taxed or under taxed. As Alex Cobham<sup>12</sup> has noted the average size of the shadow economy of low-income countries in 2002/3 is 32.7 per cent of official GDP; the equivalent for members of the European Economic and Monetary Union is 18.5 per cent. At its most basic level this means the level of tax evasion in developing economies is almost double that of developed countries.

It is unrealistic to expect that the level of unrecorded activity in developing country economies will be reduced to OECD levels within the foreseeable future. However, even halving the difference between the size of these shadow economies - thus reducing the size of the average shadow economy in the developing world to 25.6 per cent - would bring US\$58 billion into recorded GDP.

It is important, however, to avoid making the assumption that this will automatically give rise to significant tax revenues. Many of the people whose incomes might be recorded as a result of this change will be

living at or below subsistence levels. Nonetheless, recording the income is important if, as a result, this provides opportunity to protect vulnerable members of society by providing transfer payments.

Dealing with this issue requires a number of issues to be addressed, all of which are dealt with in detail in the recommendations in chapter 9, including:

- Improved and simplified accounting systems for the self-employed: an issue on which UNCTAD alone seems to be making progress<sup>13</sup>;
- Support for tax administrations;
- Design of appropriate tax systems;
- A change in the perception of taxation and all that implies for the relationship between the individual and the state.

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12 Analysis based on Cobham A, 2007 *The tax consensus has failed* presented to TJN conference, Nairobi, Kenya, January 2007

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13 See SMEGA level 3 accounting guidance from UNCTAD at <http://www.unctad.org/templates/webflyer.asp?docid=4926&intItemID=3913&lang=1> accessed 30-1-07, which is the most innovative programme in this area at the moment



## Capital flight<sup>14</sup>

Capital flight involves the deliberate **and illicit** disguised expatriation of money by those resident or taxable within the country of origin.

This process has great significance. As a result of capital flight domestic resources available for development and for financing public services are reduced. This activity also depresses economic activity and has a negative impact on long-term growth rates<sup>15</sup>.

Tax evasion is often the motive for the flight of capital and the two are implicitly linked. It is however important to note that other reasons do exist e.g. seeking a secure location for cash resources, the avoidance of local currency risk (even if that is illegal in the country in which the taxpayer is resident) or the avoidance of other legal obligations within the state from which capital flight takes place. These might, for example, relate to compulsory inheritance laws. As such it is important to note that capital flight would remain a problem even if there were no tax incentive implicit within it.

It is important to note that the tax loss from capital flight is likely to be greater than that from domestic tax evasion of initially similar value. This is because in domestic tax evasion the money that stays in the country will generate at least some tax revenue (for example sales tax or VAT when it is spent domestically) whereas capital that has fled does not generate any revenue for the state and nor does it help stimulate local economic activity and growth.

<sup>14</sup> This section is in part drawn on *Plugging the (Resource) Leaks* by Kapoor, S. Christian Aid UK, (forthcoming)

<sup>15</sup> Lessard, D.R. & Williamson, J., *Capital Flight and Third World Debt*. Washington: Institute for International Economics, 1987

Capital flight has certain characteristics that help distinguish it from normal monetary and resource flows. These are:

- Flight capital is domestic wealth permanently put beyond the reach of appropriate domestic authorities. Much of it is unrecorded because of deliberate misreporting;
- Because no (or little) tax is paid on wealth that is transferred as capital flight, it is associated with a public loss and private gain.
- Because tax evasion is illegal in many countries (though not in all tax havens) and subject to criminal sanction in most countries the management of flight capital is a form of money laundering. Offshore secrecy arrangements play a crucial part in the laundering process by enabling the origin and ownership of the capital to be effectively disguised.

It must be stressed that legal, well-documented and reported flows of wealth on which proper taxes have been paid are a perfectly legitimate part of everyday commercial transactions and do not constitute capital flight. Legal international payments include those where:

- The source of the wealth being transferred abroad is legal;
- The outflows represent fair payment in a commercial transaction;
- The transfer of wealth does not violate any laws of the country relating to foreign exchange or capital control;
- The taxes due on the capital being transferred have been paid in the country of their origin;
- The flows constitute a part of the official statistics of the country

involved and are properly reported, documented and recorded

While capital flight often occurs through similar channels to those used for the legitimate transfer of funds, it does not meet some (or all) of the characteristics listed above.

The mechanisms most commonly implicated in the flight of capital are as follows

**1. The mis-invoicing of trade transactions.** This can be done by:

- a. Under-invoicing the value of exports from the country from which cash is to be expatriated. The goods are then sold on at full value once exported, the excess being earned at that sale being the value of the flight capital;
- b. Over-invoicing the value of imports into the country from which cash is to be expatriated, the excess part of which constitutes capital flight and is deposited in the importer's offshore bank account.
- c. Misreporting the quality or grade of imported products to assist value over or under-statement for the reasons noted above;
- d. Misreporting quantities to assist value over or under-statement for the reasons noted above;
- e. Creating fictitious transactions for which payment is made. As has been noted:

*One well-worn wheeze is to pay for imported goods or services that never materialize<sup>16</sup>*

<sup>16</sup> The Economist, *Quiet Flows the Dosh: A piece on capital flight out of Russia*, 7 December 2000.

2. **Transfer mis-pricing** This is the manipulation of prices of transactions between related affiliates of MNCs. The motives are the same as those noted above for mis-invoicing, and mis-pricing can take place using the same mechanisms. This practice is discussed in more depth in chapter 4.

It must be stressed though that transfer pricing itself is a legitimate practice so long as it is undertaken using an 'arm's length principle' - that is the price be equivalent to an open market price<sup>17</sup> which would exist between unrelated entities. Expertise in getting these prices right should be prevalent because:

*Around 60 per cent of trade takes place between subsidiaries of MNCs. As these transactions occur between different parts of the same company, there is ample scope for mis-pricing and, as a result, in shifting of profits<sup>18</sup>.*

In practice prices based on the arms length principle are difficult to establish within the highly complex international production networks that exist today and where companies use trade marks, patents, brands, logos and a variety of company specific intangible assets. As is noted in chapter 4, such mis-pricing is also much more likely in the case of developing countries with neither the means to assess the risk that transfer pricing is taking place, or the resource to investigate it where they believe it is occurring.

<sup>17</sup> OECD. 2001. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD

<sup>18</sup> The Economist, *Quiet Flows the Dosh: A piece on capital flight out of Russia*, 7 December 2000

3. **Using mis-priced financial transfers.** These transactions involve either 'thin capitalisation' arrangements or involve the relocation of intellectual property which is then subject to mis-pricing. These arrangements are described in more detail in chapter 4. The capital flight that occurs through these channels shows up as a part of legitimate current or capital account transactions and is impossible to identify through official balance of payments statistics. Only a thorough transaction by transaction analysis of legitimate looking financial payments and transfers would allow authorities to capture the true extent of this phenomenon.
4. **Unscrupulous wire transfers.** These involve a bank or a non-banking financial institution transferring money out of a country illicitly. Wire transfers are of course a legitimate way of moving money between countries but it is when such transfers violate laws, or are used to avoid taxes or hide ill-gotten wealth that they constitute illicit capital flight.
5. **Other mechanisms.** These include the smuggling of cash and other high value mobile assets. Luxury yachts have been regularly sold and moved across oceans to shift capital from one country to another. Popular with journalists seeking good stories, such transfers are generally less important than the mis-pricing and wire transfer mechanisms discussed above. The illegal export of currencies (especially hard currencies) in the form of smuggling of bank notes is fairly common. Diamonds<sup>19</sup>, gold, illegal

drugs and other high value commodities such as arts, antiques and rare coins also serve as means to take wealth out of poor countries.

6. **The payment of bribes and corrupt monies offshore.** In many instances involving bribes payable to public officials by commercial organisations there is an element of capital flight involved. The payment of a bribe always means that the recipient country will not get a fair value on the commercial activity undertaken by the firm paying it and that both tax evasion and capital flight will deprive the country of scarce resources.

### 'Round tripping'

Not all the capital that flees developing countries stays out. Some of it comes back disguised in the form of what appears to be foreign direct investment. This is the consequence of the flight money being disguised offshore during the capital flight process prior to reinvestment in the country from which it originated. This is called 'round tripping'. The preferential treatment accorded to many foreign investors provides an incentive to engage in this process. For example, in the case of China foreign investors typically enjoy lower tax rates, favourable land use rights, convenient administrative supports and even favourable financial services from domestic and foreign financial institutions. They also enjoy superior property rights protection.

As a result of these incentives, it has been estimated that as much as a quarter of the more than US\$100 billion that China loses

<sup>19</sup> For example "from 1993 to 1997, Guinea reported 2.6 million carats of official diamond exports at an average of US\$96 per carat to Belgium. However, Belgium, through the Diamond High Council reported imports from

Guinea of 4.8 million carats at an average of US\$167 each" Greg Campbell, *Blood Diamonds: Tracing the Deadly Path of the World's most Precious Stones*, 2004

every year to capital flight comes back in the form of round-tripping FDI<sup>20</sup>. It is currently believed that the Chinese market accounts for the largest number of new companies registered in the British Virgin Islands each year and many of these will be associated with capital flight and round tripping<sup>21</sup>.

## Tax planning

The techniques associated with tax planning are explored in chapters 4 to 8. There is no doubt that all the issues referred to in these chapters apply to developing countries, but since none of them are peculiar to developing countries we will not elaborate the issue further at this stage.

## Tax Competition

Capital account liberalisation in the last quarter of the 20<sup>th</sup> Century greatly increased capital mobility. This process has been further facilitated by technological changes, such as the ability to move funds electronically. Increased mobility of capital has been used to apply pressure on governments to lower taxes on capital and businesses. The hypothesis put forward is that since capital is so mobile nations should compete with one another to attract inward flows of capital by offering:

- Lower tax rates on profits;
- Tax holidays;
- Accelerated tax allowances for spending on capital assets;

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20 Xioa, G. *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications*

21 Sharman, J. in *The Future of Offshore* 2007 (forthcoming)

- Subsidies;
- Relaxation of regulations, including those relating to labour, health and safety and consumer rights as well as those relating to financial disclosure;
- The absence of withholding taxes;
- Tax inducements for mobile labour required to service the mobile capital (such personnel being believed to be in short supply and subject to different forms of incentive from other forms of labour).

These ideas have been promoted by economists and business advisers who subscribe to what is commonly called the Washington Consensus.<sup>22</sup> Under pressure from the major International Financial Institutions<sup>23</sup> (IFIs) to adopt development strategies based on attracting foreign direct investment, many governments now routinely engage in tax competition by lowering taxes on capital and profits and by offering some or all of the incentives listed above to attract investment.

## The impact of tax competition on tax rates

As the data in Appendix 2 to this report on corporate tax rates shows, from 1997 to 2004:

1. Average corporation tax rates fell from 33.3 per cent to 29.1 per cent;
2. The fall in the rate was higher in the OECD at 6.7 per cent than in non-OECD

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22 For a discussion of 'The Washington Consensus' see [http://en.wikipedia.org/wiki/Washington\\_Consensus](http://en.wikipedia.org/wiki/Washington_Consensus) accessed 25-1-07

23 The IMF, World Bank, African Development Bank, Asian Development Bank, Bank for International Settlements, European Bank for Reconstruction and Development and Inter-American Development Bank

countries, where it was just 0.9 per cent;

3. The fall was smaller at 4.1 per cent on average in large countries (assessed by population size alone) than in small countries, where it was 4.6 per cent;
4. In contrast, the fall was highest where GDP was high, with a 6.3 per cent fall in rates in high GDP countries, but a fall of 2.6 per cent in low GDP countries;
5. Tax rises did occur throughout the survey period, but were far outnumbered by tax cuts.

The position seems clear. Wealthier countries appear to cut have their tax rates more than lower income countries. In reality, however, high income countries are generally better placed to defend their tax base (i.e. the profit on which tax is charged) than lower income countries (see Cobham, 2007) and as such tax rates are not by themselves a good indication of the problems arising in this area.

A clear indication of this problem with the tax base is that despite its stable tax rates and the overall underlying increasing trend in corporate profitability, the share that corporation taxes play in the total direct taxation revenue of the UK fell from 26 per cent in 1998 to just below 20 per cent in 2005<sup>24</sup>. It is clear that companies are paying a smaller contribution to the UK Treasury than they might.

This trend has to be considered in the context of developing country, where tax revenues are lower on average than their rich country counterparts, with the average revenue in South Asia for example being 12 per cent of GDP (1999-2002) less than half of the average level of 26 per

<sup>24</sup> Based on data at [http://www.hmrc.gov.uk/stats/tax\\_receipts/1\\_2\\_v2\\_dec05.xls](http://www.hmrc.gov.uk/stats/tax_receipts/1_2_v2_dec05.xls) accessed 29-1-07

cent in the OECD <sup>25</sup>. Direct tax revenues which are progressive in nature and can be used for effective redistribution are especially low; 2 to 6 per cent of GDP compared with 12 to 18 per cent for developed countries<sup>26</sup>.

The advantage has not been given to companies alone. In the UK, for example, the top decile (one fifth) of earners pay a smaller proportion of their income in tax than the bottom decile,<sup>27</sup> whilst the average top marginal rate on personal income in the OECD has been reduced from 46 per cent in 2000 to 43.2 per cent in 2005. Of the 30 OECD countries for which data is reported, 17 have reduced their top level personal income tax and only 5 have increased it between 2000 and 2005<sup>28</sup>. The effective tax rate applicable to dividend income has also been reduced from 24.7 per cent in 2000 to 21.3 per cent in 2006<sup>29</sup>.

In summary, the tax situation of the world's wealthy elites is improving as a result of tax competition. What has therefore to be considered is whether this is at the expense of developing countries.

### Tax competition: the inter-state gains and losses

The correct response by governments to increased mobility of capital should have been co-operative and collaborative, not competitive. In the same way that

<sup>25</sup> Cobham A, *Tax Evasion, Tax Avoidance and Development Finance*, Working Paper 129, Queen Elizabeth House, University of Oxford, 2005

<sup>26</sup> *ibid*

<sup>27</sup> *New Statesman*, 7 March 2005

<sup>28</sup> OECD tax database available on [http://www.oecd.org/document/60/0,2340,en\\_2825\\_293564\\_1942460\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/60/0,2340,en_2825_293564_1942460_1_1_1_1,00.html)

<sup>29</sup> *ibid*

countries have managed to impose some order and regulation on global trade flows through the WTO, it would have been (and still should be) possible to create an environment where no matter how mobile capital is, it can be taxed. This requires an effective and multilateral framework for exchange of information and enhanced co-operation in other areas with regard to tax administration and collection, all of which are discussed in chapter 6 of this report.

Instead the idea of tax competition prevailed. For example, the UK Chancellor of the Exchequer stated in his 1997 budget speech that:

*I want the United Kingdom to be the obvious first choice for new investment. So I have decided to cut the main rate of corporation tax by 2 percent from 33 per cent to 31 per cent, the lowest ever rate in the UK. This means that we will have the lowest corporation tax rate of any of our major competitors.*

And in its 2000 budget, the Canadian government stated that:

*In recent years, many industrialized countries have either reduced their corporate tax rates or announced their intention to lower them. If no action were taken, Canada's general corporate tax rate would not be competitive with those of our trading partners. The Government's objective is to reduce, within five years, the federal corporate income tax rate to 21 per cent from 28 per cent.*

President Jacques Chirac has proposed slashing France's corporation tax rate from 33 per cent to 20 per cent in January 2007<sup>30</sup>. The Finnish finance ministry, while reducing the tax rates on capital gains and corporate profits tellingly said that:

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<sup>30</sup>  
<http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/01/05/cnfrance05.xml>

*A reduction of the tax rate is unavoidable because of international tax competition*<sup>31</sup>.

But the advantage gained by one country from lowering its taxes is often short term because it is quickly offset by similar moves in neighbouring countries. This leads to long term revenue losses in all countries that engage in such short-sighted competition.

The issue is not just one of concern between nation states. Its impact can in many ways be best demonstrated by its impact within a federal state where other factors are relatively constant. As Greg LeRoy wrote in a recent issue of *Tax Justice Focus*<sup>32</sup>:

*Tax competition is an international blight, but it is also a plague within the borders of the United States. In fact, competition for jobs and tax receipts within the United States has been an 'economic war among the states' for more than three decades.*

LeRoy further comments that:

*Economic development - defined as spending by states and cities for job creation or retention - now finds the average state with more than 30 subsidy programmes: property tax abatements, corporate income tax credits, sales and excise tax exemptions, tax increment financing, low-interest loans and loan guarantees, free land and land write-downs, training grants, infrastructure aid - and just plain cash grants.*

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<sup>31</sup>  
[http://www.vm.fi/vm/en/03\\_press\\_releases\\_and\\_speeches/01\\_press\\_releases/2004/85795/name.jsp](http://www.vm.fi/vm/en/03_press_releases_and_speeches/01_press_releases/2004/85795/name.jsp)

<sup>32</sup>  
[http://www.taxjustice.net/cms/upload/pdf/TJF\\_2-4\\_on-screen.pdf](http://www.taxjustice.net/cms/upload/pdf/TJF_2-4_on-screen.pdf)



*The bottom of the iceberg - in every sense of the word - is tax breaks. Those granted by states - income, sales and excise - are the least visible, least accountable, and most corrosive ways states fund economic development. Those granted locally - especially property tax abatements and diversions - are especially harmful to schools.*

This is a particularly relevant to developing countries that have a federal structure, not least because he concludes:

*States and corporate lobbyists justify economic development tax breaks by claiming job creation and tax base enhancements. But they routinely fail to deliver on both counts..... In the second half of the 1990s, when the U.S. economy was sizzling, federal corporate income tax revenues grew an average of six per cent a year. But state corporate income tax collections rose at just half that rate. Same companies, same profits, same years, half the tax.*

This was entirely because of inter-State tax competition. Furthermore, as LeRoy reported:

*Analysing by 16 industrial sectors (such as food processing, transportation equipment, etc.) University of Iowa Professors Peter Fisher and Alan Peters found that for Texas, in 9 out of 16 sectors, companies are getting negative income taxes; in Ohio, it's 13 out of 16; and in Kentucky, 15 out of 16. In three states - Iowa, Michigan, and South Carolina - they found that in all 16 sectors, companies are getting negative tax rates!*

Covering similar ground, an academic study<sup>33</sup> from Brazil analysed the effect of

inter-state competition in Brazil, and found that:

*The fiscal cost for the country of the tax war is very high. A recent dissertation that analyzes three cases of newly installed vehicle factories (Silva, 2001) concludes that, in two of the cases, the present value of the stream of subsidies exceeds the value of the private investment; and the fiscal cost of creating a job is over US\$ 350,000<sup>34</sup>.*

*Furthermore, this does not seem to be a cost incurred to attract investment to the country. The plants would probably be located in Brazil in the absence of the tax break.*

This reveals how tax competition turns economic theory on its head, entirely negating the principle of comparative advantage which provides the basis for trade and investment theory. In practice, tax incentivisation reduces production efficiency in the majority of cases.

Despite the obvious flaws in the tax competition approach, both developed and developing country governments are now competing with each other by shifting the tax burden from capital to less mobile labour and consumption at the behest of the IFIs. When they reach the stage at which further increased taxation of labour becomes politically and economically difficult they resort to cutting government services as well. In a developing country this can only harm wellbeing and undermine job creation since the shifting tax burden lowers the cost of capital relative to labour and therefore induces

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*the literature and policy recommendations, Brazilian Political Economy, vol. 25 no 3, 2005*

34 Silva M. A. (2001) *Guerra Fiscal e Finanças Federativas no Brasil: o Caso do Setor Automotivo*. Universidade Estadual de Campinas

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33 Ferreira SG, Varsano R and Afonso JR *Inter-jurisdictional Fiscal Competition: a review of*



increased use of the former relative to the latter.

This situation has arisen because the theory of tax competition conflates the micro economic theory of the firm with the political economics of the state. This is a fallacious notion whose main use appears to be the justification of tax cuts for powerful companies and the rich.<sup>35</sup> The fact that governments do not compete with one another to provide defence, health, education and other public services to their citizens has not inhibited prominent economists from supporting the concept. Milton Friedman has said:

*Competition among national governments in the public services they provide and in the taxes they impose, is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices which they offer.*<sup>36</sup>

In contrast, *Financial Times* columnist Martin Wolf has written:

*The notion of the competitiveness of countries, on the model of the competitiveness of companies, is nonsense.*<sup>37</sup>

The logic inherent in Wolf's argument is simple and obvious. When businesses fail they are replaced by more efficient businesses, whereas when governments

fail the international community is called in to rescue the situation.

In addition, tax competition does not, contrary to the argument of those who support it<sup>38</sup>, exert competitive pressure on governments to be more efficient. Governments are not profit-maximisers in the economic sense of that term and do not collude with one another to raise tax levels in the way that businesses do to raise price levels. In a democratic system governments are accountable to their electorate, who are keenly aware of tax levels. We suggest that any electorate should be allowed to decide between high tax / high spend and low tax / low spend governments in a democratic process. Seeking to create an artificial 'competition' between different states undermines the ability of electorates to choose between these options and is fundamentally anti-democratic.

It is clear that the combination of reduced corporate tax rates, generous tax breaks and tax holidays has meant that MNC's have reduced their overall tax liabilities. This has happened in both developed and developing countries. For example, research done by Richard Murphy showed that between 2000 and 2004 alone the effective tax rates of the fifty largest UK companies fell from 26.6 per cent to 22.1 per cent at an overall costs to the UK treasury of at least £4 billion (US\$7.6 billion) annually during that period, with the trend increasing over time.

In developing countries such as Honduras, most foreign investors have no tax liability. In Senegal, Jamaica and Namibia firms have been granted permanent tax exemptions, and tax holidays provided to companies operating from export processing zones (EPZs) in countries such

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35 For evidence of the impact of President Bush's tax cuts see the evidence of Bob McIntyre of Citizens for Tax Justice in the USA submitted to the Senate Budget Committee on 24-1-07 available at [http://budget.senate.gov/democratic/testimony/2007/McIntyre\\_TaxGap012307.pdf](http://budget.senate.gov/democratic/testimony/2007/McIntyre_TaxGap012307.pdf) accessed 25-1-07

36 <http://www.freedomandprosperity.org/> accessed 1 February 2006

37 Wolf, M., (2005), *Why Globalization Works* Yale Nota Bene, p258

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38 See, for example, <http://www.heritage.org/Research/Taxes/BG1460.cfm> accessed 29-1-07

as Sri Lanka are now being stretched to as much as 20 years. Elsewhere the situation is even more fragile. In Guatemala, for example, where state expenditure barely reaches 10 per cent of GDP, tax revenues are so low that the state is in danger of disintegrating<sup>39</sup>.

### The harm from tax competition outweighs any possible benefits

More than 95 per cent of changes to investment regimes introduced since 1991 have been favourable to MNCs<sup>40</sup> and more than 120 countries now have some form of investment promotion policy in place, typically including tax breaks.<sup>41</sup>

This has happened despite the fact that evidence linking tax breaks to increased long term investment is at best ambiguous.<sup>42</sup> Though there are, no doubt, individual cases where tax rates have swayed commercial decisions on where to locate production, there is overwhelming evidence that MNCs rank quality of

infrastructure, well-educated workforce and a local dynamic market far higher in their list of priorities. All evidence points to the idea that governments have conceded too much to MNCs in exchange for too little<sup>43</sup>.

In any case, the development potential of attracting MNCs through tax breaks is limited with the total employment in developing country EPZs estimated to be between 4 - 6 million<sup>44</sup>. This is a tiny fraction of the more than 350 million jobs in the informal sector, and is wholly insignificant when compared with the more than 1,200 million people living on less than a dollar a day. Yet the outcome of providing tax incentives to MNCs is that countries in need of tax revenues are increasingly substituting taxes on wage earners or consumers for taxes on capitals. This trend is regressive, harms employment generation and increases inequality. In the longer term, tax competition increases poverty and social inequality, and slows economic growth.

Research has also made it clear that using tax incentives to attract mobile capital does not provide a sustainable basis for creating and retaining jobs. As Sheila Killian (University of Limerick, Ireland) notes:

*Countries which were successful at the first round of tax competition are now finding that tax rates alone will not hold the multinationals on which they have become so dependent. The economic growth associated with their earlier success has brought high operating and wage costs. Multinationals who have remained lightly rooted in the soil of these countries can easily move their*

39 Mold, A. 2004. 'A proposal for unitary taxes on the profits of transnational corporations' CEPAL Review 82, April 2004.

40 UNCTAD. 2003. *World Investment Report 2003: FDI Policies for development: national and International perspectives*. New York and Geneva: United Nations.

41 UNCTAD. 2004. *World Investment Report 2004: The Shift Towards Services*, New York and Geneva: United Nations

42 See McKinsey and Company. 2004. *The McKinsey Quarterly 2004 - 1*. Research by McKinsey highlights the ineffectiveness of incentives, including tax breaks, in attracting foreign investment. Also see, Morisset, J. and Pirina, N. 2002. 'How Tax Policy and Incentives affect FDI: A Review' Occasional Paper 15, World Bank. And Wells, L. and Allen, N. 2002. 'Tax holidays to attract foreign investment: lessons from two experiments', in L. Wells, N. Allen et al. *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Cost?*, Occasional Paper 15, Washington, D.C.: International Finance Corporation / World Bank.

43 Mold, A. 2004. 'A proposal for unitary taxes on the profits of transnational corporations' CEPAL Review 82, April 2004.

44 Dicken, P. 1998. *Global Shift- Transforming the World Economy* London: Paul Chapman.

*manufacturing to cheaper, emerging economies, taking with them their coveted jobs and exports.*<sup>45</sup>

## Tax competition and MNCs

Historically companies competing to make better (or cheaper) products have driven innovation and productivity increases. However, competition between MNCs is increasingly shifting to tax strategies. As a result of more or less aggressive tax planning strategies competitors are facing sharply different tax rates. For example in the 1990s - Maytag and GE (both makers of kitchen appliances) paid sharply different rates of tax with Maytag paying 35 per cent of its profits as tax and GE paying only 8.1 per cent. Abbot Labs and Pfizer, both pharmaceutical companies paid 29 per cent and 3.1 per cent respectively<sup>46</sup>.

The ability of MNCs to structure their affairs via tax havens provides them with a significant tax advantage over their nationally based competitors. National competition, no matter whether it is more technically efficient or innovative than its MNC rival, will be competing on an uneven playing field in this case. In practice, of course, this differential tax treatment favours the international business over the national one, and the long-established

business over the start-up<sup>47</sup> and the large business over the small one<sup>48</sup>.

This can impact particularly badly on developing countries where firms are usually smaller, newer and more domestically focussed than those in the developed world. Tax breaks for foreign investors, and the ability of MNCs to use aggressive tax avoidance strategies distort the playing field between domestic companies and MNCs, adding to the existing economies of scale that MNCs generally enjoy and hence stunting the growth of domestic enterprises<sup>49</sup>.

The logic of this uneven competition requires either that all businesses must move offshore in order to compete on a level basis, or that tax authorities adjust their tax regimes to place a greater burden on other factors of production (particularly labour) and onto consumption, as has been the trend in many countries over recent decades.

Increasingly, tax is also determining how companies organise themselves. The fundamental tenets of capitalism of competing on core products are being undermined as firms devote more effort to tax planning, which is not core to the business. Increasingly, tax minimisation is determining how businesses organise themselves<sup>50</sup>.

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45 Killian, S. 2007. *'Taxing Thoughts: Tax Competition and the True Cost of Intellectual Capital'* Paper given to the Tax Justice Research Workshop, held in Nairobi, Kenya, January.

46 McIntyre, R. and T. Nguyen (2000): *Corporate Income Taxes in the 1990s*, Washington, D.C., Institute on Taxation and Economic Policy, October.

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47 Christensen, J. and Murphy, R. (2004) *The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the Bottom Line*, Development, Vol.43, No.3

48 Nicodeme, Gaetan 'Do Large Companies Have Lower Effective Corporate Tax Rates? A European Survey', Solvay Business School, 2007

49 Christensen J and Kapoor S (2004): *Tax Avoidance, Tax Competition and Globalisation*, Accountancy, Business and Public Interest Vol.3 No.2, 2004

50 The Economist (2004) *'A Taxing Battle'*, 31 January

More than 60 per cent of world trade is now intra firm trade carried out between subsidiaries of MNCs with much of it passing through tax havens<sup>51</sup>. The price used for these internal transactions – the transfer price – is particularly susceptible to manipulation in order to move profits to the lowest tax jurisdictions to minimise tax liability. This practice of profits laundering is widespread with over 80 per cent MNCs surveyed in a study having reported being investigated<sup>52</sup> for transfer price abuse. Further discussion of this issue is to be found in chapter 4.

### **The promotion of tax avoidance as a strategy to enhance shareholder value**

One of the many strategies employed by those who benefit from a reduction of tax revenues resulting from tax competition is to try and make the practice of not paying their fair share of taxes appear acceptable.

According to one commentator:

*Corporate managers have spent the last century developing tools for avoiding regulation and taxation. They brag that acts of tax avoidance are part of corporate productivity. For them, each dollar of tax not paid because of their machinations is the added value they bring to a company. Tax avoidance is a profit centre. Avoidance of regulation and supervision is an equally high priority. Corporate contributions and the personal contributions of senior corporate managers have funded anti-regulatory*

*think tanks and anti-regulatory scholarship. Political contributions have turned theory into reality<sup>53</sup>.*

In fact some commentators have been even more disingenuous in trying to portray non-payment of taxes not just as acceptable but as something desirable, even necessary. For example, an Ernst & Young tax partner has claimed that:

*Tax is a cost of doing business so, naturally, a good manager will try to manage this cost and the risks associated with it. This is an essential part of good corporate governance<sup>54</sup>*

As John Christensen of the TJN has said of this comment<sup>55</sup>:

*This statement needs careful unbundling to understand its underlying politics. Firstly, a tax on profits is not a business cost but a distribution to society. This much is clear from how tax is reported on the profit and loss account alongside distribution to shareholders.*

*Secondly, the use of the word risk is revealing. What risks arise from tax other than those involving a legal challenge to an avoidance or evasion strategy?*

*Thirdly, directors wanting to pursue ethical corporate practices would generally not regard tax avoidance as acceptable practice, and are therefore likely to resent pressures from competitors who abandon ethics in favour of higher short term profits.*

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51 Transfer pricing: Keeping it at arm's length, The OECD Observer, April 2002 available at [http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer\\_p](http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer_p) accessed 29-1-07

52 Lorraine Eden (1998) Taxing Multinationals University of Toronto Press p.635 cited by Giddens (2000:102).

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53 <http://www.alternet.org/columnists/story/17356/> 11 December 2003.

54 P.J. Henahan, senior tax partner of Ernst & Young, in an article published in the *Irish Times* on 7th May 2004

55 Christensen, J. *The Corruption Interface*, TJN, 2006

*Finally, there is no requirement under company law - anywhere in the world - for company directors to minimize their tax payments, especially when this involves actions that might infringe national laws and hiding these actions from the scrutiny of shareholders and national authorities.*

The truth is that in practice shareholders do not like earnings shocks. For this reason aggressive tax strategies are detrimental to shareholder interests<sup>56</sup>. For example, when Vodafone revealed a disputed £2 billion tax liability in November 2005 it contributed to a fall in its share price of 11 per cent in one day<sup>57</sup>. This also led some to question<sup>58</sup> whether Vodafone's tax department was really fulfilling its stated aim which is:

*To maximise shareholder value in relation to the taxation consequences of all aspects of the Group's business activity.*<sup>59</sup>

Despite this obvious conflict of interest, many MNC managers have their compensation linked to the short term share price through stock option incentives. These options provide a clear incentive to use aggressive tax strategies to boost short term earnings, even when such strategies could have a high cost for shareholders in the long term.

<sup>56</sup> For a full discussion of this issue see Murphy R, 'Extracting Transparency', Global Witness 2005 available at [http://www.publishwhatyoupay.org/ifrs/pdf/extracting\\_transparency.pdf](http://www.publishwhatyoupay.org/ifrs/pdf/extracting_transparency.pdf) accessed 29-1-07

<sup>57</sup> <http://business.timesonline.co.uk/article/0,,9076-1874227,00.html>

<sup>58</sup> <http://www.taxresearch.org.uk/Blog/2007/01/23/accounting-for-tax/>

<sup>59</sup> [http://www.vodafone.com/article/0,3029,CATEGORY\\_ID\\_per cent253D3040107\\_per cent2526LANGUAGE\\_ID\\_per cent253D0\\_per cent2526CONTENT\\_ID\\_per cent253D266240,00.html](http://www.vodafone.com/article/0,3029,CATEGORY_ID_per cent253D3040107_per cent2526LANGUAGE_ID_per cent253D0_per cent2526CONTENT_ID_per cent253D266240,00.html) accessed 29-1-07

This risk to good corporate governance has been noticed by some investment fund managers. Henderson Global Investors, who have more than US\$110 billion under management, in a publication entitled *Responsible Tax*<sup>60</sup>, recommended that large corporations:

1. be open with the tax authorities;
2. be wary of excess complexity in structures designed to reduce tax;
3. have tax arrangements that are consistent with the 'real world business';
4. maintain good relations with the tax authorities and not engage in actions that risk damaging their corporate reputation;
5. abide by both the letter and the spirit of the law; and
6. be socially responsible.

The same theme was taken up by leading CSR agency Sustainability in its 2006 report *'Taxing Issues- Responsible Business and Tax'*<sup>61</sup>. It is also appropriate to note that two of the Big 4 firms of accountants have also addressed this issue in response to the Tax Justice Network's (TJN) campaigning on this issue.<sup>62</sup>

And, there is good reason for shareholders to be wary of companies which use off balance sheet structures, shell companies

<sup>60</sup> Henderson Global Investors, *Responsible Tax*, 2005

<sup>61</sup> See <http://www.sustainability.com/insight/research-article.asp?id=450> accessed 29-1-07.

<sup>62</sup> See KPMG's 'Tax in the Boardroom' available at <http://www.kpmg.co.uk/services/t/cts/tcs/tms/strategy.cfm#> and PricewaterhouseCooper's initial publication on the 'Total Tax Contribution' published 2005 but no longer available on any website.



and other offshore structures to aggressively 'manage' their balance sheet, tax and cash flows. Such structures were used by the likes of Enron, Parmalat and WorldCom to both avoid taxes and hide losses.

## The cost of tax competition to stakeholders

The concept of focusing on maximising shareholder wealth alone was briefly challenged by the 'stakeholder' management concept in the 1990s as corporate social responsibility gained in popularity.<sup>63</sup> A firm's stakeholders will include its customers, staff, suppliers and the government and society of the jurisdictions it operates in amongst others. Shareholder value seems to have the upper hand in this debate at present.

Clearly, a firm that engages in aggressive tax minimisation strategies is not being managed in the interests of its stakeholders including the government which provided its licence to operate<sup>64</sup>. This policy, amongst other defects, fails to recognise that governments are themselves large consumers of the goods and services produced by firms. Many of the largest corporations receive tens of billions of dollars of government contracts. This mutuality extends the obligation of firms with such relationships, though this behaviour is not evidenced in practice.

In the US, for instance, a US Senate Government Accountability Office study found that in 2001 four large companies - Accenture, Tyco, Foster Wheeler and McDermott International received US\$2.7

billion worth of US government contracts and yet all these firms were based in tax havens to minimise their tax liability. Accenture, for instance, paid just 7 per cent of its profits in taxes worldwide from 1997 to 2000<sup>65</sup>. Furthermore, a number of companies such as Halliburton that have obtained large contracts for military support and the reconstruction of Iraq are amongst those with the largest number of subsidiaries in offshore tax havens<sup>66</sup>.

This trend is widespread. As was noted by Martin Sullivan<sup>67</sup> in 2004:

*The profits of foreign subsidiaries of US corporations in 18 tax havens soared from US\$88 billion in 1999 to US\$149 billion in 2002.*

Multinational corporations derive large benefits from their operations in developing countries. For instance the World Bank has reported that the average rate of return on Foreign Direct Investment (FDI) in developing countries is 18 per cent with the return in sub Saharan Africa being as high as 36 per cent<sup>68</sup>. MNC's benefit from the availability of cheap unskilled labour (in countries such as Bangladesh), a cheap yet highly educated workforce (in countries such as India) and the availability of abundant and easy to extract natural resources (in countries such as Zambia and South Africa). Yet despite the fact that they and their

65 Reported in 'Having their cake and eating it too - the big corporate tax break', ICFTU, 2006

66 Cray, C. and Drutman, L. 'Sacrifice is for suckers: How Corporations Are Using Offshore Tax Havens to Avoid Paying Taxes', A Citizen Works briefing paper, <http://www.citizenworks.org/corp/tax/taxbreif.php>

67 Sullivan, M. *Tax Notes* 13 September 2004.

68 *Private Capital Flows to Developing Countries: the Road to financial integration*, World Bank 1997

63 For a discussion of the issues see [http://en.wikipedia.org/wiki/Stakeholder\\_concept](http://en.wikipedia.org/wiki/Stakeholder_concept) accessed 29-1-07

64 This issue is discussed in depth at <http://www.sustainability.com/insight/research-article.asp?id=450> accessed 29-1-07

shareholders derive enormous benefits from these operations evidence points to the fact that MNC's seek to reduce their developing country even more aggressively than in rich countries.

### **The cost of tax competition to developing countries**

A recent study<sup>69</sup> reported that during negotiations on the privatisation of the Zambian copper mining sector, MNCs negotiated the already low 3 per cent royalty provision that Zambia had in place down to just 0.6 per cent. The same report also points out that despite the booming price of copper and record profits the actual royalty paid in 2004 (the most recent year for which data is available) was an just 0.02 per cent with a total of only 0.7 per cent (including taxes) of the production value accruing to the state.

The result is clear. The non-payment of taxes in rich counties no doubt has severe negative repercussions but the impact is invariably higher and starts from a lower base of revenue in developing countries.

### **Fiscal impacts of trade liberalization on developing countries**

Another area in which developing countries have fared worse than their developed country counterparts has been the fiscal impacts of the trade liberalisation programmes promoted by the IFIs and national development agencies. Whilst there is little doubt that trade has the capacity to have a significant positive impact on development, one aspect of trade liberalisation that has received little attention has been the fiscal impact of the

significant cuts in trade taxes that are central to the liberalisation process.

Import tariffs are amongst the easiest taxes to administer and hence have contributed significantly to revenue income for many developing countries, sometimes to the tune of 30 - 50 per cent of total government revenue. In the last two decades, under pressure from the IMF and World Bank, developed countries have pursued an aggressive trade liberalization agenda which involved a sharp reduction of import tariffs.

While the overall impact on the economies may be somewhat debateable, the fiscal impact of these tariff reductions was largely negative. The IMF has attempted to quantify the fall in government revenues as a result of reducing import tariffs and concluded that the fiscal impacts vary remarkably between countries at different stages of development. For example, high income countries, which derive only a small share of tax revenue from trade taxes, have been able to recover revenue from other sources, principally consumption taxes. Middle income countries have fared less well, recovering between 45 -65 per cent of the fiscal revenues they lost.

The situation has been dramatically worse, however, for low income countries. As the IMF itself notes:

*Troublingly, however, revenue recovery has been extremely weak in low-income countries (which are those most dependent on trade tax revenues): they have recovered, at best, no more than 30 cents of each dollar lost. Nor is there much evidence that the presence of a value added tax has in itself made it*

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<sup>69</sup> A Rich Seam: Who benefits from the commodity price rise? Christian Aid UK, 2007



*easier to cope with the revenue effects of trade liberalisation.*<sup>70</sup>

The fiscal outcome of trade liberalisation for many developing countries has been that the (regressive) value added tax regimes substituted for trade taxes, have fallen far short of revenue replacement, overall revenues have fallen, and the tax burden has been shifted from imports (often of luxury goods) onto the basic goods and services consumed by low income households.

### **Holding governments to account**

The last source of tax leakage identified in chapter 1 is that arising from the existence of poor tax administrations. This might be, and often is, the result of those administrations being under-resourced or under-trained, but the failure by some governments to provide political support for the collection of tax or the legal enforcement mechanisms for tax collection exacerbates this further. In combination, these factors provide opportunities for abuse of the tax system both by domestic and foreign entities and create the opportunity for capital flight.

These situations can also be exploited in developing countries. As Christian Aid has reported,<sup>71</sup> MNCs use a variety of tactics to negotiate lucrative tax deals with the governments of developing countries and to ensure that as little tax as possible is paid to them. They note:

*Most developing country exporters receive a tiny fraction of the profits from the minerals extracted from their soil. As well*

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70 Baunsgaard, T. and Keen, M. (2005) *Tax Revenue and (or?) Trade Liberalisation*, IMF Working Paper, WP/05/112

71 Ibid, downloaded from [http://www.christianaid.org.uk/indepth/0701mining/Mining\\_per\\_cent20Report\\_per\\_cent20complete.pdf](http://www.christianaid.org.uk/indepth/0701mining/Mining_per_cent20Report_per_cent20complete.pdf) accessed 25-1-07

*as deals which allow companies to pay much lower taxes than those they pay in richer countries, firms also employ various tax avoidance tactics to get money out of developing countries. New figures compiled by Christian Aid show that there is significant under-pricing of exports to avoid tax. Our research found under-pricing valued at between 0.1 and 29 per cent of total exports in 2005.*

These issues are discussed in more depth in chapter 4.

What is clear is that because taxation lies at the heart of the relationship between a government and its citizens, accounting for tax and other forms of government revenue must be transparent. We stress, this is an issue for developed, transitional and developing countries.

Such accountability has benefits. For example, when Uganda started publishing the amount of money being sent by the federal government to each of the local councils, the leakage of funds was reduced drastically from about 50 per cent to less than 5 per cent as the local population started holding the local politicians and bureaucrats to account.

### **The particular problem with the extractive industries**

What is clear though is that whilst accountability to citizens is important when they pay the majority of the taxes a government receives (which is commonplace) this is harder when a large part of government revenue is derived from resource extraction as happens in many developing countries. This weakens the incentive for citizens to hold the government to account whilst the governments involved can fall into the trap of thinking they have a 'right' to the

resource that is independent of their accountability to their citizens.

These (and other problems) give rise to the so called 'resource curse'<sup>72</sup> whereby countries rich in natural resources have a tendency to be badly governed, have lower growth rates, and a higher probability of conflict.

It is widely believed that transparency in the amount of royalty and taxes generated through the extractive sector can improve accountability and citizen incentive to engage with the government and hold it to account. This perception arose as a result of the Global Witness report '*A crude awakening*'<sup>73</sup> which promoted awareness of this issue. That report concluded with a public call on the oil companies operating in Angola to "*publish what you pay*". The wider Publish What You Pay<sup>74</sup> campaign was launched in June 2002 and called for the publication of all payments made to governments by oil, gas and mining companies in a easy to understand and accessible manner.

Following the lead taken by PWYP initiative, the same year British Prime Minister Blair launched the Extractive Industry Transparency Initiative<sup>75</sup> which is supported by the UK Department for International Development and also works closely with the IMF and the World Bank.

As the EITI has evolved it has become clear that all it does is reconcile the figures that companies say they have paid to governments to the payments government say they have received. The process did not seek to determine whether the sum paid was correct. In other words, the truth and fairness of the process is not addressed by the EITI reconciliation process. As campaigners came to realize, knowing that 95 per cent of the revenues companies have declared are accounted for by governments is of little value if the declared payments are only half the real sum due<sup>76</sup>.

Since then, the TJN has worked with PYWP to tackle this issue. The first result was a proposal for an international accounting standard for the extractive industries<sup>77</sup>. This was subsequently expanded to be a proposed standard that tackled the issue for all companies subject to the international financial reporting standards whatever sector they worked in<sup>78</sup>. The importance of this issue is addressed again in chapter 9 of this report but it is important to stress that it is believed that this mechanism could provide valuable information to assist identification of:

- Where MNCs operate;
- What they are called in those locations;
- What the scale of their activity is in each country in which they operate;

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72 For further explanation see [http://en.wikipedia.org/wiki/Resource\\_curse](http://en.wikipedia.org/wiki/Resource_curse) accessed 29-1-07

73 Available from [http://www.globalwitness.org/media\\_library\\_detail.php/93/en/a\\_crude\\_awakening](http://www.globalwitness.org/media_library_detail.php/93/en/a_crude_awakening) accessed 29-1-07

74 <http://www.publishwhatyoupay.org/> accessed 29-1-07

75 [http://www.eitransparency.org/section/about\\_eiti](http://www.eitransparency.org/section/about_eiti) accessed 29-1-07

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76 See Murphy, R '*Making it Add Up*', Global Witness, 2005  
[http://www.globalwitness.org/media\\_library\\_detail.php/130/en/making\\_it\\_add\\_up](http://www.globalwitness.org/media_library_detail.php/130/en/making_it_add_up) accessed 29-1-07

77 [www.publishwhatyoupay.org/english/objectives/ias.shtml](http://www.publishwhatyoupay.org/english/objectives/ias.shtml)

78 [www.taxresearch.org.uk/documents/ias14final.pdf](http://www.taxresearch.org.uk/documents/ias14final.pdf)

- How much tax they pay in each country in which they operate;
- Those MNCs operating complex structures;
- Which MNCs engage in offshore arrangements (which it must be added, might be legal);
- Those MNCs that need to be questioned on their activities by a wide variety of stakeholder groups.

The authors of this report consider this an effective way of making MNCs more accountable for their actions, which could yield two results. Firstly, the tax paid by an MNC to a government will be more readily identified because the payment will be on public record. This is vital. Secondly, and as importantly, governments - as stakeholders of those MNCs with the final responsibility for assessing the tax due by them - will have an overview of the structure of that MNC across all the countries in which it operates. This will help them:

1. Assess the likely supply chains within the MNC, and so determine whether there is a risk that trade mis-pricing needs to be investigated;
2. Calculate whether it is likely that a fair part of the value added by the MNC is being recorded in their territory i.e. an overall assessment of the application of the 'arms length' rule might be possible so that risk can be determined;
3. Comparative performance between MNCs can be checked.

Because this would be done globally, corporations could not object to being subject to unfair disclosure requirements, and the pressure on any government, whatever its relative strength is eliminated. When added to the benefits for other stakeholders outlined in the submissions made in support of this idea, the TJN believes it an important element

in any strategy intended to raise additional taxation for development, and to hold governments and MNCs accountable for their resulting actions.

## Corruption

The accountability of both governments and the private sector is important because corruption is a fact of life.

The TJN does, however, have a very particular view of corruption, summarised in John Christensen's paper *'Mirror, Mirror on the Wall, Who's the most Corrupt of all?'* (attached as appendix 4 to this report.)

In that paper he argues that the current pre-occupation of developed countries and institutions such as the World Bank with corruption is based on too narrow a definition of the issue, which chooses to ignore the central role played by developed country institutions, the offshore financial infrastructure, MNCs and professionals in the supply of what might be called 'corruption services'.

It is indisputable that corruption is an impediment to development. When government funds are not used as those who provided them intended, ordinary people suffer. Paul Wolfowitz has during his tenure at the World Bank made this a focus of his strategy<sup>79</sup>. However, he has broadly accepted the definition of corruption promoted by Transparency International, which is<sup>80</sup>:

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<sup>79</sup> See for example <http://www.nytimes.com/2006/09/14/business/14wolf.html?ex=1315886400&en=cb130a950d337b28&ei=5088&partner=rssnyt&emc=rss>

<sup>80</sup> [http://www.transparency.org/news\\_room/faq/corruption\\_faq](http://www.transparency.org/news_room/faq/corruption_faq)

*Corruption is operationally defined as the misuse of entrusted power for private gain*

We do not dispute that this approach to corruption has served a purpose. It has succeeded in highlighting an issue that needs to be addressed in developing countries in particular. But there are substantial problems with this definition:

1. It focuses on the symptoms and not the cause of this problem;
2. It emphasises corruption within government, or corruption as crime;
3. It ignores illicit corporate activity;
4. It specifically ignores the issue of tax evasion as corruption.

As John Christensen has noted<sup>81</sup>:

*In terms of orders of magnitude, the proceeds from bribery, drugs money laundering, trafficking in humans, counterfeit goods and currency, smuggling, racketeering, and illegal arms trading account in aggregate for 35 per cent of cross-border dirty money flows originating from developing and transitional economies. In contrast, the proceeds from illicit commercial activity, incorporating mispricing, abusive transfer pricing and fake and fraudulent transactions account for 65 per cent of such flows.<sup>82</sup> The very least one might expect in such circumstances, is that equal emphasis be given to corruption in both private and public spheres; that greater prominence be given to how corruption can reduce tax revenues by as*

*much as 50 per cent;<sup>83</sup> and that the activities of the offshore system should be more carefully scrutinised to ascertain the harmful impacts of tax havens on the functioning of global markets and on the integrity of the rule of law.*

*Regrettably, Transparency International, despite its commendable role in putting corruption onto the political agenda, has undermined the efforts of reformers through its publication of the Corruption Perception Index (CPI) which reinforces stereotypical perceptions about the geography of corruption. Africa, in particular, is consistently identified by the CPI as a nexus of corruption, accounting for almost half of the bottom quintile of countries in the 2005 index. Only one African country, Botswana, features amongst the least corrupt quintile. But closer examination reveals that about 40 per cent of the countries identified by the CPI as least corrupt are offshore tax havens, including major centres such as Singapore (ranked 5th overall), Switzerland (7th), United Kingdom (11th), Luxembourg (13th), Hong Kong (15th), Germany (16th), USA (17th), and Belgium and Ireland (jointly 19th). For good measure Barbados and Malta, both offshore tax havens, rank 24th and 25th respectively. What do these rankings tell us about the current politics of corruption? I find it hard to disagree with the prominent Nigerian who, during protracted negotiations to secure the repatriation of assets stolen by former Nigerian President Sani Abacha, commented that:*

*"It is rather ironical that the European based Transparency International does not think it proper to list Switzerland as the first or second most corrupt nation in the world for harbouring, encouraging and*

81 Quoted from [http://www.taxjustice.net/cms/upload/pdf/Follow\\_the\\_Money\\_-\\_RGS-IBG\\_final\\_31-AUG-2006.pdf](http://www.taxjustice.net/cms/upload/pdf/Follow_the_Money_-_RGS-IBG_final_31-AUG-2006.pdf)

82 Baker, R. (2005) *Capitalism's Achilles Heel*, John Wiley & Sons, Hoboken, New Jersey, p369

83 *The Other Side of the Coin: The UK and Corruption in Africa*, report by the Africa All Party Parliamentary Group, March 2006, p12

*enticing all robbers of public treasuries around the world to bring their loot for safe-keeping in their dirty vaults.<sup>84</sup>*

TJN proposes that a change in how we perceive corruption is required. Perceptions of corruption need to be broadened to include those illicit commercial activities most closely associated with trade mispricing (in all of its various guises) and tax evasion.

In addition, the focus must shift from the 'demand side' for corruption, which is the sole focus of attention within the TI definition as used by the World Bank. The 'supply side' is important and since that is the case corruption has to be considered to include:

1. The activities of those governments who supply the secret spaces in which corruption can take place, which include (but by no means exclusively) the recognised tax havens;
2. Those who supply the services that allows such corruption to happen including the bankers, lawyers, accountants and trust companies who set up and operate such arrangements;
3. Those who undertake illicit transactions related to capital flight and tax abuse;
4. Those who ignore such transactions in the course of their duties.

These activities provide what we term a 'corruption interface', linking the illicit economy of dirty money flows to the mainstream global economy. Without this financial interface it would be far harder to hide corrupt practices from investigation and to protect the proceeds of crime from seizure. For this reason TJN

argues that the supply side should be tackled every bit as vigorously as the demand side. Only by adopting this dual approach will this problem be effectively tackled. In the absence of a dual track approach, developing countries are being unreasonably penalised for the involvement of some in their governments in corruption whilst those who facilitate these activities are going unpunished. In addition, until corruption is categorised in this way the loss of taxation revenues from developed countries because of tax corruption facilitated by places such as Luxembourg, Switzerland and the British tax havens will be more readily tolerated by society. This cannot be ignored any longer.

## Summary

Developing countries face particular issues when it comes to taxation but the problems they face are not theirs alone, and are by no means entirely of their own making. As the TJN's argues in this report, most of the underlying causes of these problems are located in the developed world even though it is developing countries who suffer most from them.

It is unacceptable to say that action is not possible on these issues because developing country corruption prevents it.

It is not possible to say that weak tax administration cause this problem when developed countries and the accounting bodies located in them take no action to ensure that those administrations have the information they need to tackle these issues at an international level.

It is impossible to ignore the role of tax intermediaries and the MNCs of the world in creating the structures in which trade mis-pricing abuse of all forms takes place.

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<sup>84</sup> Former Education Minister Professor Aliya Babs Fafunwa quoted in *This Day*, 6<sup>th</sup> June 2005

It is the responsibility of the IFIs to say that tax competition has caused harm, as some (but too few) economists now realise.<sup>85</sup>

It is impossible to continue turning a blind eye to the fact that:

*respected accounting firms, banks, investment advisors and lawyers have become high-powered engines behind the design and sale of abusive tax shelters. The evidence showed that these professionals were collecting hundreds of millions of dollars in fees while robbing the U.S. Treasury of billions of dollars in revenues each year<sup>86</sup>.*

The cumulative impact of these issues on the tax compliance<sup>87</sup> of billions of ordinary people has to be taken into account when considering the tax lost for development.

It is for precisely this reason that much of this report, whilst focussed firmly on the issue of using taxation to raise the funds needed for the fulfilment of the MDGs and more, addresses this issue in the context of action that can be taken in any and every country, developed, transitional or developing.

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85 Lynch, R., (2004) *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, Washington D.C.

86 From the web site of Senator Carl Levin <http://levin.senate.gov/senate/investigations/index.html> accessed 30-1-07

87 For definition see Chapter 4



## Chapter 3

# The scale of the flooding

### The Sources

Estimating the scale of the tax lost as a result of the leaks in the tax system identified in chapters 1 and 2 is immensely difficult. The sources of the leaks are as follows:

1. Tax due on the shadow economy (economic activity which is not captured in official statistics and constitutes tax evasion).
2. Tax due on income earned from assets which are held offshore: that is, by individuals using tax havens.
3. Tax due on income earned by multinationals and then moved offshore without paying appropriately (through e.g. transfer pricing).
4. Tax that would have been received had not rates been diminished by tax competition between jurisdictions seeking to attract foreign investment
5. Tax due but not paid; a potentially large leakage where enforcement mechanisms and administration are under-funded, and/or penalties for non-payment are small and therefore tax avoidance in all its forms is rife.

The value of the sums in question have been most recently reviewed by Alex Cobham of Oxford University in a paper for the TJN conference in Nairobi, Kenya in January 2007<sup>88</sup> and the estimates

offered here are based on his work unless otherwise indicated.

As Cobham notes, international data sources are available to attribute values to leakages 1-3; comparable values for leakages 4 and 5 are not currently available and some estimates will have to do.

### The Price of Offshore

Research by TJN (2005)<sup>89</sup> estimated the offshore assets of high net worth individuals at US\$11.5 trillion. This translates, having taken conservative assumptions on estimated rates of return and possible tax paid whether by source or voluntary declaration into account, into an annual tax loss due to individuals' use of tax havens at US\$255 billion.

It is important to note that this figure does not include the offshore holdings of corporations. However as noted by US tax columnist Martin Sullivan<sup>90</sup> in 2004:

*The profits of foreign subsidiaries of US corporations in 18 tax havens soared from US\$88 billion in 1999 to US\$149 billion in 2002.*

Despite substantial evidence on the shift taking place, Sullivan was unwilling to

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88 Cobham, A, The tax consensus has failed! Oxford Journal on Good Governance, January 2007 available at <http://www.oxfordgovernance.org/fileadmin/Publications/ER008.pdf> accessed 29-1-07

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89 The price of offshore available at [http://www.taxjustice.net/cms/upload/pdf/Price\\_of\\_Offshore.pdf](http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf)

90 Sullivan, M. Tax Notes 13 September 2004.



estimate the cost to the US Treasury that resulted. What was clear to him though was that:

*It would be foolish to assume anything other that the Treasury has many billions of dollars on the line.*

Using a different approach, Richard Murphy for the TJN estimated that the tax lost as a result of the 50 largest corporations in the UK not paying the tax at the headline rates expected of them resulted in:

*Over 5 years, these companies have thus paid £20 billion less tax on their profits than expected rates would suggest appropriate<sup>91</sup>*

Extrapolated over the UK economy as a whole he estimated the loss to be £9.2 billion (US\$17,5 billion) a year. It is not clear how much of this was due to which leakage noted above. What is clear from these combined findings is that the tax lost from the corporate sector is significant and additional to that noted from individual activity.

Cobham (2005)<sup>92</sup> builds on the TJN estimate of US\$255 billion and using an earlier estimate Oxfam (2000)<sup>93</sup> of the annual losses to developing countries from corporate profit laundering reports annual losses of US\$100 billion of tax revenue for developing countries with

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91 Murphy R, *Mind the Tax Gap*, 2006, page 2 available from [http://www.taxjustice.net/cms/upload/pdf/Mind\\_the\\_Tax\\_Gap\\_-\\_final\\_-\\_15\\_Jan\\_2006.pdf](http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_final_-_15_Jan_2006.pdf) accessed 29-1-07

92 Cobham A, *Tax Evasion, Tax Avoidance and Development Finance*, Working Paper 129, Queen Elizabeth House, University of Oxford, 2005

93 Oxfam, *Releasing the Hidden Billions for Poverty Eradication*, 2000 [http://www.oxfam.org.uk/what\\_we\\_do/issues/debt\\_aid/tax\\_havens.htm](http://www.oxfam.org.uk/what_we_do/issues/debt_aid/tax_havens.htm)

both individual and corporate components contributing US\$50 billion each.

## The Price of the Shadow Economy

Cobham's estimate of the tax losses inflicted on developing countries by the existence of shadow economies uses is based on an average shadow economy size of about one third of GDP in low income economies. Using this Cobham arrives at a figure of annual tax loss of US\$285 billion of which US\$110 billion is recoverable in his estimate by appropriate action to close the floodgates.

## The Total Tax Losses - Excluding Tax Competition

Using these cautious estimates as a starting point for our analysis, if multilateral action were taken to curb the widespread abuse of the offshore system and if developing countries were given appropriate help to reduce the size of their domestic shadow economies, then developing countries could increase their annual domestic resource mobilization by over US\$200 billion (\$50 billion dollars from revenues secured from individuals using offshore; US\$50 billion from corporate abuse as referred to in the Oxfam report; and just over US\$100 billion from recovery from the shadow economy). This alone comes to twice the amount of overseas development aid that is currently being disbursed.

## Capital Flight

Raymond Baker (2005)<sup>94</sup> has estimated that global cross-border flows of dirty money range between US\$1.06 trillion and US\$1.6 trillion annually of which between US\$539 billion and US\$829 billion comes from developing and transitional economies. He breaks these down further and estimates that two thirds of this flow is driven by commercial motives (including reducing or eliminating the payment of taxes) and only about a third is related to drugs and trafficking etc related crimes. The extent to which this sum is recoverable depends upon adoption of many of the measures suggested in this report.

Simon Pak's work in Chapter 11 of this report suggests that value shifting into the USA alone might exceed US\$250 billion per annum, and this calculation is based on a massive empirical dataset.

Epstein et al (2005)<sup>95</sup> have calculated and compiled estimates of capital flight for a number of developing countries. Their estimates show that for example South Africa has been losing an average of 9.2 per cent of GDP (losing US\$13 billion in 2000), China 10.2 per cent of GDP (losing US\$109 billion in 1999), Chile 6.1 per cent of GDP (losing US\$4.7 billion in 1998) and Indonesia 6.7 per cent of GDP (losing US\$14 billion in 1997).

This indicates a very large aggregate number for total annual capital flight from developing countries which again seems to fall in the ball park estimates of dirty money flows (\$539 billion to US\$829

billion annually from developing countries) in Baker (2005).

## The Tax Gap

While all these estimates may appear to be very large, country level estimates of the tax gap in the US and UK help put them in perspective which suggests that these figures may be conservative. The US Inland Revenue Service for instance estimates that the annual tax gap in the US is about US\$345 billion<sup>96</sup>. However, in an ongoing hearing session at the US senate, this figure has been described as a significant underestimate being:

*based on old and limited research ... and leaving out some of the most important things ... [such as] offshore tax-sheltering schemes<sup>97</sup>.*

Even with this limited number, the cumulative tax gap estimate since 2001 has been estimated to exceed US\$2 trillion already<sup>98</sup>.

The likelihood of this figure being an underestimate is amplified when one looks at the comparable tax gap calculation for the UK, an economy one tenth the size of the US economy. The UK annual tax gap has been estimated by Tax Gap LLP (2006) to exceed £75 billion or about US\$150 billion at current exchange rates<sup>99</sup>. In fact there have been other

<sup>96</sup> [http://www.treasury.gov/tigta/congress/congress\\_07262006.pdf](http://www.treasury.gov/tigta/congress/congress_07262006.pdf)

<sup>97</sup> [http://budget.senate.gov/democratic/testimony/2007/McIntyre\\_TaxGap012307.pdf](http://budget.senate.gov/democratic/testimony/2007/McIntyre_TaxGap012307.pdf)

<sup>98</sup> <http://finance.senate.gov/press/Bpress/2005/press/prb072606d.pdf>

<sup>99</sup> <http://www.taxresearch.org.uk/Blog/2006/12/08/ho-w-much-does-tax-evasion-cost-the-uk-start-at-per centc2 per centa375-billion/>

<sup>94</sup> Baker, R. (2005) *Capitalism's Achilles Heel*, John Wiley & Sons, Hoboken, New Jersey

<sup>95</sup> Gerald Epstein et al, 2005: *Capital Flight and Capital Controls in Developing Countries*, Northampton, MA.

higher estimates one of which states that the annual tax loss due to avoidance is likely to be £100 billion<sup>100</sup> and another which is attributed to leaked UK Treasury papers of between £97bn and £150bn to tax theft every year<sup>101</sup>.

These massive losses of tax revenue have a very negative impact on the economy and society of the countries experiencing them. For example, in his testimony to the US Senate, the chairman of the US Inland Revenue Service said<sup>102</sup>:

*The tax gap can have corrosive effects upon our entire tax administration system and the fiscal health of the nation. The tax gap's consequences are all too real and we feel them in our everyday lives.*

*First, at the most basic level, the tax gap is an injustice. It means that honest taxpayers are bearing the financial burden of those who do not pay what they owe. The taxpayers who play by the rules - regardless of income bracket - pay more in taxes to make up for those who game the system and cheat. In a very tangible way, honest taxpayers are subsidizing those who evade their taxes.*

*Second, it deprives our government of revenue to which it is entitled.*

*Third, and perhaps most troubling, the tax gap undermines confidence in the fairness of our tax administration system and contributes to non-compliance.*

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<http://politics.guardian.co.uk/comment/story/0,9115,1562889,00.html>

101

<http://society.guardian.co.uk/publicfinances/comment/0,,1986352,00.html>

102

<http://www.senate.gov/~finance/hearings/testimony/2005test/072606rw.pdf>

Adam and Bevan (2004: 60)<sup>103</sup> comment on the failure of the tax consensus for developing countries to produce the desired revenue *outcomes*:

*Remarkably enough, however, very similar tax structures and tax rates seem to generate very different revenues in different countries. The reason presumably lies in different levels of taxpayer compliance and of the efficiency of tax administration, and this is where a government's discretion to increase revenue lies.*

Cobham argues<sup>104</sup> that governments' discretion to address non-compliance in the whole economy is powerfully undermined by international tax evasion:

*The main findings [from the experimental economics literature] are these: that compliance depends positively on (i) the perceived or expected level of redistribution, and (ii) individuals' expectation of others' compliance levels (Bosco & Mittone, 1997<sup>105</sup>; Mittone, 2006<sup>106</sup>). The implication is that paying tax is a social act (Frey & Torgler, 2006<sup>107</sup>) - reflecting*

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103 Adam, C., and Bevan, D., 2004, 'Fiscal policy design in low-income countries', in T. Addison & A. Roe (eds.), *Fiscal Policy for Development*, Palgrave Macmillan/UNU-WIDER: Basingstoke

104 Cobham, A., 2007, 'The tax consensus has failed!', *Oxford Council on Good Governance Economy Recommendation* 08. pages 5-9

105 Bosco, L., and Mittone, L., 1997, 'Tax evasion and moral constraints: Some experimental evidence', *Kyklos*, pp.297-324.

106 Mittone, L., 2006, 'Dynamic behaviour in tax evasion: An experimental approach', *Journal of Socio-Economics*.

107 Frey, B., and Torgler, B., 2006, 'Tax morale and conditional cooperation', CREMA Working Paper 2006-11.

*a desire to participate in a group, rather than economic maximisation.*

*As a result, it can come as no surprise that the consensus has also failed in addressing the problem of non-compliance. Non-compliance is self-reinforcing in the presence of obvious evasion by rich individuals and large companies, and a lack of redistribution exacerbates these effects.*

*Torgler & Schneider (2007a<sup>108</sup>, b<sup>109</sup>) show that the size of the shadow economy depends directly on the level of 'tax morale' - that is, the 'belief in contributing to society by paying taxes' (2007b, p.8). The estimated US\$385bn of tax revenues lost annually by developing countries are seen to be primarily driven by the international tax evasion of corporates and rich individuals that also undermines this tax morale, enlarging the shadow economy.*

*To address the issue of lost annual revenues in excess of the aid budget, developing a culture of compliance is key. From this it follows that the high-profile evasion by multinationals and individuals through tax havens must be tackled first, and as an immediate priority.'*

The agenda for action is clear.

## Theft

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108 Torgler, B., and Schneider, F., 2007a, 'The impact of tax morale and institutional quality on the shadow economy', CREMA Working Paper 2007-01

109 Torgler, B., and Schneider, F., 2007b, 'Shadow economy, tax morale, governance and institutional quality: A panel analysis', CREMA Working Paper 2007-02

While a lot of the discussion above has related to the opportunity cost - the tax that should have been paid but was not paid, sometimes the loss can also include a substantial amount of actual cash loss from a country's finances. This is exemplified by the so called 'Carousel Tax Fraud' in the UK. This VAT fraud is estimated to have costs the UK alone sums in the range from £1.1 billion to £1.9 billion for 2004/05. These sums increased to figures in the range £5 billion to £10 billion (\$4.5 billion to US\$18 billion) in 2005/06<sup>110</sup> with another estimate reported to be £8.4 billion<sup>111</sup>. Corruption is not limited to developing country economies, as is also noted in this report. One feature in common though is that almost all this lost cash is believed to have been channelled through one offshore bank - the First Curaçao International Bank in the Netherlands Antilles<sup>112</sup>.

## Summary

It is not possible to estimate the precise cost of the flood of tax revenues that are not being used for their rightful purpose in the world.

It is clear, however, that in combination the sums involved could more than cover the cost of the Millennium Development Goals, probably several times over. Of course, it is also not clear how much of this loss is recoverable, but Alex

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110 <http://www.moneyweek.com/file/17602/how-carousel-fraud-is-putting-the-vat-system-in-a-spin.html> and <http://business.guardian.co.uk/story/0,,1943994,00.html>

111 <http://news.bbc.co.uk/1/hi/programmes/panorama/5366914.stm>

112 See <http://www.guardian.co.uk/crime/article/0,,1877288,00.html> accessed 29-1-07

Cobham's estimates suggest that the potential sums which could be recovered are sufficiently large to make this a more than worthwhile project. Indeed, nothing else could raise as much cash both for the development agenda and to ensure that developing countries can mobilise their own resources for this purpose. In terms of orders of magnitude, tackling capital flight and tax evasion is probably the biggest issue on the finance for development agenda.

## Section 2

### How the floodgates are opened

## Chapter 4

### How companies reduce their tax bills

*Companies can manage their tax bills in three ways, each of which has its own description. For the sake of clarity these are worth noting:*

1. **Tax evasion** is an illegal activity undertaken to reduce a company's tax bill. It might be for example that the company:

- a. Fails to declare all or part of its income;
- b. Makes a claim to offset an expense against its taxable income which it did not incur or which is of a type not considered suitable for tax relief in the country in which the claim is made;
- c. Makes a tax claim which looks legal but only because a relevant fact with regard to that claim has not been disclosed to the tax authorities, and if it were the tax claim would be denied.

2. **Tax compliance** is the other end of the spectrum from tax evasion. When a company seeks to be tax compliant it does the following:

- a. Seeks to comply with tax law in all the countries in which it operates;

b. Makes full disclosure of all relevant information on all its tax claims;

c. Seeks to pay the right amount of tax required by law (but no more) at the right time and in the right place.

*This activity attracts remarkably little attention, but some companies do practice it.*

3. **Tax avoidance**. Tax avoidance is the grey area between tax compliance and tax evasion. When tax avoiding a company seeks to ensure that on of these happens:

- a. less tax is paid than might be required by a reasonable interpretation of the law of a country, or
- b. tax is paid on profits declared in a country which does not appear to be that in which they were earned, or
- c. tax is paid somewhat later than the profits to which it relates were earned.

*The difference between tax avoidance and tax compliance is that tax compliance seeks to ensure that tax is paid in accordance with a straightforward interpretation of the letter of the law whilst tax avoidance seeks to reduce tax*



*paid by working between the letters of the law. Both can claim to be legal, but only tax compliance can justify that claim with certainty. Tax avoidance relies on the existence of doubt for its validity. The practices referred to in this report fall largely in the area of tax avoidance, and suggest ways in which companies seek to minimise their tax bills whilst working around the law of one or more countries.*

## Tax planning

Any company, anywhere in the world has the opportunity to undertake tax planning within the law of the territory in which it operates. Sometimes this planning is a simple matter of making choices between various options quite deliberately made available within taxation law about how a transaction may be treated. This is an issue of tax compliance. On other occasions the planning may seek to find loopholes within the domestic law of the country in question, at which point it moves into the area of tax avoidance. The range of domestic options for planning available to companies is so wide, and yet are so locally specific that the purpose of this paper is to consider those options that are instead available to international companies, because these tend to be easier to categorise and are of greater significance for those involved with international justice, development and the interaction of taxation and the relief of poverty.

International tax planning can take place whenever a company trades across an international boundary, but it is much more likely to take place when a company actually undertakes its activities in more than one country. When this happens it becomes a multinational corporation (MNC). It is likely that less than 10 per cent of the world's companies are part of

MNCs<sup>113</sup> and maybe less than 1 per cent are the parent companies of multinational groups but it is estimated that their intra-group sales (i.e. transactions across international borders but between companies with common ownership) account for more than 60 per cent of world trade<sup>114</sup>.

To understand this it is important to note that whilst MNCs like to appear to be one entity, and indeed will publish accounts that suggest this is the case, MNCs are typically consist of large numbers of separate companies. A parent company usually owns all or most of the others, and controls all the others because ownership of a company's shares provides that right in company law. The companies that the parent owns are called its subsidiaries. There can be just a few of these. There may be thousands. For example, a recent count at BP suggested it had more than 3,000 subsidiary companies around the world<sup>115</sup>.

This means that whilst the corporation may like to present a single front to the world, and one published glossy set of accounts, the reality is that when it comes to taxation there is no such thing as an MNC. Each company that makes it up is taxed separately. It will usually be taxed in one of two places. The first is the country in which it is incorporated. For example, a company established under English law is always taxable on its worldwide income in the UK. Secondly it may be taxed where it trades. So, for example, a company incorporated in England but which has a branch in France

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113 This is based on the fact that only 0.5 per cent of all companies in the UK are plcs. Even if each has 20 subsidiaries on average in the UK that means 90 per cent of the register is UK based. Proof of this is not possible.

114 OECD Observer April 2002

115 BP Annual Return appendices dated 5 May 2005, lodged at Companies House in the UK

will be taxed in France in the first instance on the income of the French branch and then, for a second time in the UK, but with credit given for the French tax already paid under the terms of the double tax treaty between the UK and France which has as its intention the elimination of double taxation. It is precisely because of the complications that this arrangement causes that most MNCs have separate companies for each activity they undertake in each country in which they operate. As a by product the resulting complex structure is guaranteed to provide enormous opportunity for an MNC to plan its taxation liabilities. The ways in which it might do so include decisions on the following:

1. Where it will incorporate its head office;
2. Where it will incorporate its subsidiary companies;
3. Whether it will use tax havens or not;
4. What companies it will, or will not include in its group structure (which means which ones are added into the glossy accounts, and which ones are not);
5. On what terms it will trade between group companies.
6. Where it will record its sales;
7. Where it will incur its costs;
8. Where it will locate its assets;
9. Where it will employ its staff;
10. Where it will borrow money;
11. Where it will locate its intellectual property;
12. How it will structure its operations;
13. Whether it will seek special tax privileges.

This is a long list. Each needs to be explored to show how a group of companies might plan its taxation affairs.

### 1. Where to locate a head office.

This requires deciding in which country a head office will be located. Sometimes the decision relates to what are called 'intermediate holding companies' instead.

The importance of the decision is determined by the fact that a company usually has to pay tax in the country in which it incorporated. So, choosing to locate a company in a high tax territory such as the USA (which has amongst the highest corporate tax rates in the world) can be expensive<sup>116</sup>. However, quoted companies usually need to be incorporated in a major financial centre such as London, New York or Frankfurt. The result is that tax cannot be minimised in those locations.

Instead companies set up what are called 'intermediate holding companies'. These are owned by the parent company and in turn own the operating subsidiary companies. Little or nothing happens in the intermediate locations, except that they collect dividend income from the subsidiary companies they own and then usually loan, but not pay as dividends, the resulting cash that they hold to the parent company in London, New York, or wherever. The intermediate location is chosen for having low tax rates on dividend income received, a lot of double tax treaties with other countries to ensure that it is not treated as a tax haven (even though it is) and a favourable regime for taxing interest income, of which it may have a great deal. The most popular locations are Ireland, the Netherlands, Luxembourg and Switzerland, all of which offer these arrangements.

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<sup>116</sup> See Appendix 2 on corporate tax rates for comparative company data.

## 2. Where a company will incorporate its subsidiaries.

A combination of tax law and other regulation makes it almost certain that an MNC will have subsidiary companies in each territory in which it operates. But then it has to decide if it needs others in locations that are purely tax driven.

Non-tax haven countries tend to have higher tax rates than the tax havens. A few geographically smaller developed countries, such as Ireland and the Netherlands also offer low tax rates on profits of some or all sorts. In this they join with the tax havens in seeking to increase their tax revenues by attracting profits to their shores which were not earned there but which are relocated to that country using some of the mechanisms described elsewhere in this report.

Any group of companies has a simple decision to make. It has to decide if it wants to relocate its profits from the place in which they were really earned to places in which they may be declared, with reasonable chance of getting away with the relocation, with lower taxes being paid in consequence.

Many MNCs claim they have a duty to their shareholders to minimise the tax that the company pays<sup>117</sup>. There is in fact no such requirement in the law of many countries, including that of the UK where a much wider degree of discretion is provided to the directors of companies as to how they might manage the affairs of the entity they manage<sup>118</sup>. In that case, this claim of

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118 This issue was the subject of much debate during the passage of the UK's Companies Act 2006 through Parliament and it is clear as a result that whilst profit is important a much broader range of obligations need also to be considered by UK company

a 'duty' is actually used as an excuse to justify chosen corporate behaviour.

## 3. Whether a company will use tax havens or not

This question is related to that of where subsidiaries may be located, but not entirely. There may of course be a valid reason for locating a subsidiary in what is called a tax haven if a real trade is undertaken there. For example, a retail company running a store in Guernsey may wish to have a Guernsey based company for that purpose, and no suggestion of tax avoidance would result. However, when planning a group structure a company does have to decide if it not only wants the tax advantages some countries, such as the Netherlands, supply but the lack of transparency that is also usually associated with tax havens where accounts and even proper ownership details do not have to be filed on public record.

Some companies undertake transactions which they would prefer not to disclose to the public, their shareholders, competitors, or regulatory agencies including tax authorities. The anonymity provided by tax havens allows them to obscure the reporting of the trades they undertake in order to secure profit for their groups of company.

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directors. See section 172, Companies Act 2006 available at [http://www.opsi.gov.uk/ACTS/acts2006/ukpga\\_20060046\\_en.pdf](http://www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en.pdf) accessed 25-1-07

It would be interesting to speculate what change in behaviour might result from explicit changes in legislation in this area. Clauses requiring companies to comply with the spirit of taxation law in all the territories in which they operated were introduced to the House of Lords during the debate on the UK Companies Act (partly at the suggestion of the TJN) but were rejected by the government.

It is now almost universally agreed that transparency reduces risk, enhances the quality of corporate governance, reduces corrupt practices (including fraud) and must therefore be of benefit to society. But not all companies behave as if the interests of society coincide with those of their shareholders. If that is their opinion tax havens may well be attractive to them because the risk of their trade being subject to serious scrutiny is reduced. On the other hand, they face questions as to the reasons for their choice of location from both taxation authorities and others, but might believe this a price worth paying for secrecy.

Such decisions are rarely made for taxation reasons alone.

#### **4. Which companies will, or will not be included in the group structure**

It seems logical to assume that all companies over which an MNC has control should be included in its group accounts and so be subject to scrutiny as part of its operations. Many companies, however, choose to hide transactions “off balance sheet”. This may be because the companies in question include liabilities that they would rather not recognise since they would make the MNCs’ finances look worse; or those companies are being used to undertake transactions that change the view of the MNCs financial results e.g. by inflating profit (as was the case in the notorious situation of Enron).

MNCs can take advantage of situations where they can create ‘orphan’ companies. These are usually companies which are heavily dependent on the MNC for the trade that they undertake but which are theoretically not owned by it. This is usually achieved by placing ownership of the orphan company in a charitable trust located in a tax haven. This structure is then claimed to move both ownership and control of the orphan

company outside the group so that its transactions may be treated as if undertaken by an independent third party. This technique is often used for financing debt e.g. from credit card customers, the customers of utility companies or mortgages, but the technique can also be used for other purposes, as Enron proved all too clearly<sup>119</sup>.

The use of what are clearly artificial structures created by professional people e.g. lawyers and accountants who claim independence from their clients whilst clearly working under their direction and control, raises questions about the ethical standards of these professions.

#### **5. What terms of trade will be used between group companies**

When companies engage with their customers or suppliers (‘third parties’) it is assumed that each party is out to get the best deal possible for themselves and that the resulting prices set for the trade will reflect that fact. These are called ‘arms length prices’. However, when two companies that are under common ownership trade with each other they do not necessarily want the best price for each individual company but may be motivated to set a price that gives the best overall result for the MNC of which they are a part. This will be influenced by the amount of tax that is, or is not, paid as a result of the consequent allocation of profit between the two subsidiary companies. For example, a company in Cyprus (tax rate 10 per cent) selling to a French company (tax rate 33.33 per

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119 For a broader discussion of this issue see pages 12 – 17 of a report written by the author of this paper for a Scrutiny Committee of the States of Jersey available at <http://www.taxresearch.org.uk/Documents/4180-12935-2962005.pdf> accessed 25-1-07

cent)<sup>120</sup> has a strong incentive when both are owned by a UK parent company to overstate the selling price in Cyprus if the third party selling price in France is fixed because this will mean more profit is taxed in Cyprus at a lower rate than is charged in France than would otherwise be the case. This process of selling between related companies in an MNC is called 'transfer pricing' and is completely legal. Abuse of transfer prices may be illegal however, depending upon the countries involved.

MNCs have to set transfer prices. There can be no trade within the group if they do not. When doing so, however, they are in a position to make choices. Since before the Second World War the principle has been established in international law that prices between related companies in an MNC should be set on an 'arms length basis'. This is believed to result in the allocation of the profit earned to the country in which it was generated and this is considered a just and equitable outcome.

Companies can decide whether they want to achieve this outcome. They can use their best endeavours to do so. It must be stressed however that this is not straightforward. There may be no way of determining the 'third party' price for some products transferred across international borders e.g. the price of a part finished component that will never be sold in that state to a customer has by definition no 'arms length price' and so estimates have to be made. Such process of estimating can be undertaken in good faith, or with the intent of disguising the reallocation of profit. Likewise, companies can decide to only operate 'arms length prices' in locations where a challenge to their policy is likely e.g. in

the major developed economies where these matters are now subject to routine enquiry by tax authorities. This is not the case in developing countries. In December 2004 the Big 4 accountants Deloitte reported in South Africa that they had never seen a successful transfer pricing challenge out of Africa<sup>121</sup>, and most countries in Africa do not at present have the legislation, the expertise or the commercial confidence to raise such challenges against the MNCs that operate there.

## **6. Where a company will record its sales**

It is inevitable that an MNC will trade internally. When doing this it can relocate transactions to give rise to favourable outcomes for taxation and other purposes. One transaction that can be relocated is where a sale is recorded.

Some products can be recorded as being sold from almost anywhere, and it is hard to prove that the claim is wrong. This is particularly the case with software and other such products sold on-line over the internet.

Where real, physical products are involved it can be harder to relocate where a sale is recorded, but by no means impossible. For example, in the case of a mining company ore is extracted from the ground. That ore is, in the vast majority of cases destined for export. Decisions can be made as to where the sale of that ore is to be recorded. In the first instance, there must be a sale from the country in which it was extracted. That is obvious. But the condition in which it is sold is clearly a decision, and that can be tax

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120  
<http://www.kpmg.com/Services/Tax/IntCorp/CTR/> accessed 7-11-06

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121 Reported in *tax us if you can* TJN 2005 available from  
[http://www.taxjustice.net/cms/upload/pdf/tuyc\\_-\\_eng\\_-\\_web\\_file.pdf](http://www.taxjustice.net/cms/upload/pdf/tuyc_-_eng_-_web_file.pdf) accessed 25-1-07

driven. If the tax rate in the country of extraction is high, the ore may be shipped in unprocessed state even if that increases transport costs. The added value resulting from processing then takes place elsewhere. Alternatively, the ore can be processed first. That changes its value. The decision as to where to undertake this process changes the location in which the sale of the processed ore is located.

Even if the ore is not processed, alternative arrangements can be made for its sale. For example, it might be sold straight to a third party for processing. Alternatively, it may be sold within the MNC to a central marketing organisation (a common arrangement) which then adds a profit margin for the work it undertakes. As a result part of the sale price has been relocated from the country of origin of the ore to the country in which the marketing operation is located, which may well be a tax based decision.

Some of these decisions may be determined by genuine external factors e.g. the capacity of the country of origin to process the ore. Often they are not.

#### **7. Where a company will incur its costs**

Just as there is an incentive to shift sales to low tax areas, there is an opposite incentive to shift costs to high tax areas where they will benefit from the greatest value of tax relief. This can be of importance for developing countries with relatively high tax rates. For example, many South American countries engaged in the extractive industries have nominal tax rates in 2006 of around 25 per cent.

Companies may decide to load costs into territories with relatively high tax rates. This trend may be exacerbated if this 'cost loading' gives rise to other benefits as well. Such a benefit might arise by inflating the apparent cost of production

in the extractive industries, for example, which can have the benefit of both reducing tax and reducing the proportion of production due to the host government under some mining and oil concessions, so giving a double benefit to the company engaging in such practices.

Cost loading can be as hard, or harder, to identify than sales mis-pricing since in many cases it will be even harder to establish a market price for the items in question. The principle of the 'arms length rule' of pricing still applies in these cases, but companies have considerable discretion over how they can interpret that obligation.

#### **8. Where a company will locate its assets**

A company has to buy certain physical property to undertake a lot of the work that it does. In the extractive industries, for example, this might include all the mining or drilling equipment it uses. Logically these would be owned in the country in which they are used by the entities which have the benefit of using them in their operations. In tax planning little is that simple.

The reason is that many countries offer special incentives to companies that invest in capital assets and give them tax reliefs and allowances which are much more generous than the accounting charges made for their use in the owning company's published reports. The result is that the effective tax rates of the companies are reduced and the dates for payment of tax are deferred.

These reliefs can be exploited when combined with asset leasing arrangements. Some countries provide tax relief on the cost of assets that are leased to the legal owner i.e. the lessor. Others provide it to the lessee who hires the



asset. If the lessor company gets the tax relief on ownership then it is also liable to tax on the income arising on the asset. Conversely, in countries where the lessee gets relief on the expenditure incurred on creating the asset they rent the lessor who has legal ownership of that asset is usually exempt from tax on most of the income it gets from renting it.

Companies can decide to exploit these rules for their benefit. They do this by a process called 'tax arbitrage' where they chose to locate transactions so that they get maximum tax benefit from them by trading off the rules of one country against the rules of the country that is taxing the other side of the arrangement.

So, for example, they might lease an asset from a country which gives generous reliefs both for expenditure on capital assets and also on the incomes received by the lessor company. The outcome of these favourable treatments is that the lessor company generates considerable up front tax losses on the deal, which are only cancelled out over a considerable period, and that company then leases the asset to a territory where the lessee company gets the relief on the capital cost of the expenditure, but no tax relief on the rentals paid. This means that company also gets considerable up-front tax relief compared to cash expense incurred. The result is something called 'double dipping' in tax terms, where two lots of tax relief have been generated on one expense in effect, with in this case the transaction taking many years (maybe 25 years) to reverse, about which no one cares much since they will no longer be in their jobs by the time any reversal of the effect takes place.

As a result assets are frequently legally owned in locations far removed from those where they are actually used.

## 9. Where a company will employ its staff

It seems logical that a company would employ its staff where they work. And so it can be for those who are on average earnings for the location in question. The company is likely to rely on these people to be the backbone of their operation, and those people are also unlikely to be either significantly mobile as to the location in which they wish to work or to be willing to engage in any serious tax planning on their employer's part.

But this might not be true for the more senior management of an MNC, many of whom will have joined it precisely because it offers the opportunity to work in a number of locations. They will most probably be internationally mobile and will be willing to participate in tax planning for their own and their employer's benefit.

The result is that these senior managers might be employed in locations which suit tax planning even if their duties are undertaken elsewhere. In fact, the split between the employment location and the place in which duties are undertaken may be deliberate. The reasons are:

- a. Managers might obtain a favourable tax treatment for their earnings if they are employed in a location which is not their long term home. This is because part of their income might not be taxed anywhere.
- b. The employer may choose to place the employment in a location where the tax or national insurance charges on employing the manager are low, as is typically the case offshore.
- c. Having a manager employed offshore allows the employer to create a new business based in the offshore location which supplies 'management services', the value of which for transfer pricing purposes is hard to

prove so that profit can be extracted in this way from the company that receives the charge for these services.

A company might decide to organise their employment structures in this way for three reasons:

1. It allows them to manipulate their tax arrangements by adding another international service into the group which can be used for the purposes of profit reallocation to low or zero tax jurisdictions;
2. It can reduce the cost of employing staff;
3. It can increase the net reward to staff, so encouraging them to stay at no extra cost to the employer.

But in each case the local market for labour is upset. Overseas staff are favoured over local people. Allegiance to the company is greater as a result than allegiance to place. The duty of the staff to any particular country is undermined. And mobile staff who are dependent on their employers to create artificial structures which inflate their earnings tend to be more compliant, less inclined to whistle blow and more tolerant of other abuses if they happen within or without the company because that culture will pervade their own employment environment.

#### **10. Where a company will borrow money**

All business activities require finance to establish a physical presence in a location and to fund the day to day activities of the business. This money can be provided in two ways: share capital or loan capital. Share capital earns dividends payable from profits. Loan capital is paid interest regardless of whether or not profits are generated. Loan capital can be supplied

by an external source e.g. a bank or venture capitalist group, or from an internal finance company within a group of companies. Internal finance companies are often set up offshore in locations such as the Netherlands and Ireland which have deliberately created tax structures to attract such 'businesses'.

Interest is much more favourably treated for tax than dividends. Interest is deducted from the paying company's profits for tax purposes and so reduces its tax bill. This does not apply to a dividend. Dividends can be subject to tax withholding from the country in which they arise i.e. part of their value has to be paid to the host country government. This is by no means always true of interest. A company can often arrange to receive interest in a low tax area and create a permanent tax saving. This is harder to achieve for dividends, especially if there has been tax withholding before they are paid.

The outcome of this different treatment is predictable. Companies have a bias to loan capital. So great is this incentive that by choice they will use almost no share capital and will have substantial loan capital in a foreign subsidiary. This is called 'thin capitalisation'. This reduces the profits in high tax areas because interest is paid from them, and also reduces the overall tax bill within the group because it allows for the interest to be received in a low tax area. The company might also, unless there is regulation in place to stop it, seek to charge whatever rate of interest it likes to maximise the profit it can extract from subsidiary company in a high tax area to then transfer it to a low tax location.

Companies undertake this activity to maximise their financial return from the activities in which they invest by creating what can, quite often, be arbitrary financial structures motivated not by the

needs of group financing but by a desire to abuse tax rules for the sake of increasing the after tax profit.

The abuse is often complex. For example, third party funds are borrowed in territories with relatively high tax rates and efficient capital markets where there is no restriction on the use of those funds when it comes to giving tax relief. The UK is an example of such a location.

The funds are then lent with very low margins earned to a financial centre e.g. Dublin. From there they are loaned on to foreign subsidiaries and the charge is inflated, especially if that subsidiary is in a high risk area such as a developing country, with the justification being that the funds to be used there if borrowed directly would have been subject to a higher rate of interest even though the group itself is not.

In effect this is another form of transfer pricing abuse, but this time on financial products created specifically for this purpose.

This practice is normally well regulated in developed countries, but this is not generally the case in developing countries.

### **11. Where the company will locate its intellectual property**

This decision perpetuates a recurring theme throughout this discussion, which is one of how an MNC might structure its affairs in order to maximise the number of transactions crossing international borders. Doing this maximises the opportunities for relocating profit to low tax areas.

Intellectual property comprises patents (on which royalties are paid) and copyrights (on which licence fees are

paid). There are other variations on this theme but these two categories are sufficient to cover most issues.

Intellectual property may have been acquired by an MNC from a third party or, more likely, has been created by it. For example, Audi claim they filed 9,621 patent applications when creating their new A6 car. Any company might decide where it wishes to locate ownership of its patents or copyrights and this need not be the country of their creation, with little or no tax penalty arising on relocating them to a low tax country before they have been used and have therefore been proved to have commercial worth. The same is true of copyright material, such as logos. The Virgin corporation, for example licences the use of its Virgin logo to all Virgin operations from the British Virgin Islands. Microsoft holds the copyright of most of its products for sale outside the USA in Ireland - a low tax state. The result is that it appears to be largest company in Ireland, though the vast majority of its income in that country has little or nothing to do with its activities in that country.

It is notoriously difficult to prove the value of intellectual property. This means it is an especially popular mechanism for shifting the location of profits from both developed and developing countries into low tax locations.

Almost any company can 'create' licensed intellectual property. Even its own name can fall into this category. In many cases the legal registration of this property is quite unnecessary. The charging of a fee for its use is quite often even less justified.

An MNC has to decide if it wants to undertake this activity which is largely designed to facilitate the shifting of profits to low tax areas.

## 12. How a company will structure its operations

This theme brings together a number of previous threads. It involves decisions on:

1. Where to incorporate;
2. Where to borrow;
3. Where to place subsidiaries and intermediate holding companies.

Each of these, and indeed the other issues addressed above, can be seen as discrete decisions. But they are also viewed collectively by most MNCs. What they are seeking to do is to create a structure for their MNC which minimises tax. In doing so they are likely to:

1. Make full use of taxation treaties between countries to ensure that the least possible tax is deducted at source from any dividends, royalties, interest or licence fees paid, thus ensuring they arrive in the parent company with as little paid in tax as possible;
2. Secure favourable tax treatment by accumulating reserves in low tax jurisdictions such as the Netherlands, Ireland and Switzerland with an extensive range of double tax treaties;
3. Seek to use 'conduit' companies to turn income from relatively unacceptable sources e.g. those subject to a tax holiday (e.g. in a developing country) into an acceptable source to which a double tax treaty exemption from further taxation can be applied. Cyprus is frequently used for this purpose.
4. Seek to exploit loopholes between double tax treaties to minimise tax obligations e.g. by double dipping as noted above. This practice has recently been attacked by a number of tax authorities.

Other possibilities occur and are exploited by some companies.

The decision the company makes on this issue is essentially political. It is one of deciding whether the corporation exists within national spaces called countries, and is therefore subject to the rules and regulations of those spaces, or whether it wishes to float above and between those spaces and exploit the gaps between them by finding loopholes in the double taxation treaties that regulate the international taxation environment.

The current structure of accounting encourages MNCs to see themselves as independent of any nation state. The accounts that they publish are 'consolidated'. They do not actually represent the results of any individual company within the group. Instead they represent the net outcome of the transactions between all the MNCs and third parties. But transactions within the MNC are entirely eliminated from that reporting.

As a result the local base for each and every company within the MNC is ignored in the published accounts, which consequently float above the national spaces as if independent of the locations in which the company works.

This perception is one that many companies now replicate in their tax planning. They can create complex group structures knowing that they do not have to report on them. They can also exploit the gaps between the countries in which they either work, or in which they choose to locate operations for the benefit (as they see it) of their investors (even though they are, inevitably rooted in those self same national spaces) because whatever they do is similarly unaccountable.

The structures of international tax have also until recently encouraged this because they have been poor at exchanging information between nation states or at enforcing international taxation liabilities. The consequence has been that an ethos of abuse has developed, with the interests of the company being seen as superior to those of the state.

The company has to decide whether to accept this philosophy, or not.

### **13. Whether a company will seek special tax privileges**

There is a final option available to companies. They might simply ask the state for special tax concessions.

Sometimes these are given by way of grants or subsidies. On occasion they are given by special tax allowances e.g. by granting accelerated tax allowance for capital expenditure in certain industries which have the effect of ensuring that MNCs in that sector do not pay tax for an extended period even though they are profitable. They can simply involve taxation holidays granted to particular companies whilst they are establishing themselves in a territory e.g. a ten year period is common in this respect. Alternatively, they can involve specially negotiated tax rates as is frequently possible in tax havens.

The final option is to negotiate what is called a 'fiscal stability clause' which guarantees the company that the state's tax laws will not be changed to its prejudice for the foreseeable period. This period can be 25 years or more. These provide certainty to the company undertaking inward investment but seriously limit the scope for future economic management through use of

fiscal policy on the part of the country that offers them.

The acceptability of these practices varies. Some subsidies and grants are almost above suspicion. Special tax allowances are usually beyond international reproach if offered to both local as well as incoming businesses. This is sometimes acceptable to a government because there is almost no local trade of similar type. Tax holidays and negotiated tax rates are widely frowned upon and income subject to such regimes is usually denied the benefit of the favourable treatment often afforded by double tax treaties. However conduit tax havens such as Cyprus can often be used to convert income of this unacceptable sort into income that is acceptable under double tax treaties.

In all cases there is a direct conflict in these arrangements between the state and the MNC, with the balance being decided between the amount of estimated economic benefit the state secures when traded against the tax it loses. If, however, the incentives offered are linked to unacceptable commercial practices the balance of the equation quickly moves into areas where fraud and other malpractice is either suspected or occurs in practice. When that is the case the state is unlikely to benefit from the negotiated arrangements even if the MNC does.

In deciding whether to avail itself of these options the company has to assess the risk to its reputation from doing so. A company might also consider whether it is allowing tax to cloud its commercial judgement: there are studies showing that tax incentives often result in business activities being undertaken in areas which are not favourable and that the outcomes do not meet the expectations of either the business or the government.

There is limited risk in taking opportunity of available tax reliefs or grants. There is increasing risk as a company moves into negotiating special allowances, tax holidays, special rates and fiscal stability clauses. Some companies choose not to do this. Others use the opportunities provided by the rules of corporate reporting, which allow intra-group transactions to be largely ignored to suppress details of such trading. This is done in the hope that the negative aspects of such deals can be kept out of scrutiny whilst the positive advantages to cash flow are enjoyed.

Along with many of the decisions to be taken by a company with regard to the issues listed in the paper, this is an ethical choice and the MNC has a position to take on this issue which it cannot avoid, and about which it should be open and accountable.

#### **Example: What companies in the Extractive Industries do to reduce their tax bills**

One of the most problematic industries in developing countries, and certainly the one to which more attention has been given than most, is the extractive industries. As an example of what can actually happen, companies in the extractive industries have a range of choices they can make to shift profits with little or no tax paid from the host countries in which they operate. These might be summarised as follows:

##### **1. Negotiate favourable local tax arrangements**

The MNC will seek to secure a favourable position for itself by negotiating special tax arrangements under the terms of its mining or oil extraction concession.

- a. Negotiate tax holiday so that tax is not paid during the first years of the

life of the project. 10 years is commonplace.

- b. Negotiate special tax allowances for investment e.g. 100 per cent write off of capital costs to create early year trading losses which mean tax is not paid for some considerable time;
- c. Secure grants, allowances or subsidies for the operation which have the same effect as tax allowances, or might even be additional to them;
- d. Negotiate exemptions from domestic tax laws e.g. on tax withholdings from dividend payments so that profits may be extracted tax free. This is particularly attractive if no other tax is being paid during a tax holiday on profits;
- e. Negotiate special tax rules so that limited questions are asked on the expenses charged against profits within the local operation of the MNC, thereby reducing its taxable profits;
- f. Seek a fiscal stability clause for its own long term benefit, but not that of the host state;
- g. Seek special transfer pricing arrangements e.g. so that ore or oil is exported at prices below market rates e.g. on the basis of production costs plus a fixed mark-up, whatever the movements in price in the market place.
- h. Seek allowance for the vast majority of capital to be invested in the local operation to be in the form of loans so that 'thin capitalisation' can take place and profits can be extracted from the host country by way of interest payments. Prior negotiation may take place to ensure that there are no limits on the rate of interest that may be charged.
- i. Ensure that no limitations are placed on royalty and licence fees paid by



the company located in the host country.

## **2. Establish tax effective holding company arrangement for the host country operating company**

The company seeks to ensure that profits that have not been taxed or which have been subject to low rates of tax in the host country retain that benefit when moved out of that territory.

Any special tax incentives offered by a host country will probably negate the benefit of double tax treaties with major financial centres where the MNC will have its headquarters e.g. the UK, the USA, etc. As a result a structure will be created that ensures that the profits flow from the host country to a low tax state with reasonably good double tax treaties (e.g. Cyprus, which is a full member of the EU) and from then on they will flow through what are called 'participation agreements' in jurisdictions like the Netherlands. This ensures that the benefits of low or no tax paid are preserved as the profits flow either into the parent company, or more likely into a group financing operation in the country running the participation agreement such as the Netherlands or Switzerland. These group financing operations are effectively intra-group banks which ensure that low taxed profits never have to reach countries with higher tax rates but are instead loaned to them.

## **3. Source all equipment to establish the host country operation from within the group**

Supplying services and capital equipment from within the group means that prices charged can be arranged to ensure that profits flow to low taxed countries through the manipulation of transfer prices on sales into the host state. This

has the dual advantage of reducing the taxable income of the host country operation and inflating its cost of production of ore or oil, which will probably reduce the royalties due to the host country as well.

- a. Capital equipment will be sold or leased to the host country operation from another company within the MNC which is either in a low tax area or which allows a double tax deduction to be made on leased equipment costs by claiming the expense in two locations - a process known as 'double dipping'.
- b. Management services and seconded staff will be supplied from offshore locations to reduce the tax paid locally on employment costs, thus reducing the benefit to the host country of the operation being undertaken within their state, and to enable such costs to be sold to the host country operation at inflated prices, with the resulting benefit being transferred to a low tax state;
- c. Charges will be made for the use of MNC owned patents, copyrights and 'management know-how', the ownership of which will be located in offshore tax havens. The value of this knowledge will be hard to prove and as such is particularly difficult to challenge under transfer pricing rules.
- d. Cash needed to fund the operation will be provided by group finance companies in locations such as the Netherlands, Ireland or Switzerland where low rates of tax are charged on the receipt of such income. This is especially likely if a tax holiday has not been negotiated.

## **4. Arrange for sales to be made through group marketing arrangements.**

International sales are meant to take place at what are called 'arms length

prices' under international tax conventions. The intention is to ensure that each country obtains the correct market price for the commodity sold from its territory and so taxable profits are correctly allocated between states.

Arms length prices have to be negotiated in MNCs since by definition they do not operate at arms length when selling on an intra-group basis and MNCs can exploit this in a number of ways to ensure that profit is extracted from its host country operation and moved to another territory where it might be more favourably treated.

- a. The MNC might seek to negotiate that 'arms length prices' do not apply to its sales from the host country. This is not uncommon.
- b. If arms length pricing is required the group might supply only limited, or no information to prove that this is actually the case.
- c. If arms length pricing is to take place the MNC will seek to ensure that there is no market comparison for its product e.g. it will be argued that the ore or oil extracted is significantly different from that available elsewhere and as such negotiated prices have to be used.
- d. Sales will be made from the host country to a group marketing company, typically located in a tax haven. The group marketing operation will claim a margin for the 'services' it supplies, thus reducing the price available in the host country.
- e. Ensure that processing of the ore or oil takes place outside the host country. This means that value is added elsewhere, thus suppressing the price paid to the host country. It also allows valuable side products (e.g. silver contained in copper ore) to be

marketed from outside the host country. That makes transfer prices much harder to negotiate.

- f. Require that the ore or oil be sold with the benefit of group marketing arrangements for which a licence or royalty will be payable, usually to a tax haven.

### Summary for the Extractive Industries

Given the range of options available to them, MNCs have considerable opportunity to plan their taxes. The range of opportunities available for tax planning are so large that most MNCs are able to engage in tax avoidance, which necessarily means the assumption of risk of getting such arrangements wrong. If they are undertaken without full disclosure of the nature of the transactions being made to all the parties involved they face the risk of being considered tax evasion, at which point these activities can be considered illegal. It is often the case that the divide between tax avoidance and evasion is one of judgement.

To minimise this risk for their shareholders and to ensure that the MNC settles its obligations as a corporate citizen in the states in which it really undertakes its activities it is recommended that any MNC undertake as few of the noted practices as possible.

*Note: The research included in this chapter was sponsored by Christian Aid to whom thanks are extended for the opportunity to reproduce it here.*

## Chapter 5

# How individuals reduce their tax bills

Numerous opportunities present themselves for individuals to reduce their tax bills. As with corporations, individuals can choose to manage their affairs in one of three ways:

1. Tax evasion;
2. Tax compliance, and
3. Tax avoidance.

Each term has the same meaning for individuals as it does for corporations. Tax compliance is the process that tax authorities promote and which represents the behaviour of a responsible citizen. Tax evasion is illegal neglect of the responsibilities imposed by tax law. Tax avoidance lies between the two, so whilst likely to be legal it involves abuse of normal understanding of taxation law.

### Tax planning

Tax planning happens when a person seeks to manage their tax liabilities. The ways in which an individual might do this can cover a wide range of taxes e.g.:

1. Income taxes;
2. Social security contributions;
3. Value added tax (VAT) or Goods and services taxes (GST);
4. Capital gains taxes;
5. Wealth or inheritance taxes;
6. Duties and other charges e.g. on imports, trading or particular

contracts and products, many of which will be luxuries;

7. Gift taxes;
8. Environmental taxes;
9. Taxes from countries other than their own.

Given this wide range of taxes, and because the actions an individual takes to avoid one tax often have impact on the amount of another tax they pay, this area is especially complex and the variety of mechanisms used are enormous and vary from country to country. The following generalisations are possible, however:

1. **Poor people don't plan their tax bills.** There are three good reasons:

- They don't have tax bills;
- They cannot afford to pay the costs associated with tax planning;
- Tax planning usually requires the person undertaking it to have income in excess of their current needs: by definition this excludes most people from the activity.

2. **The wealthiest in society have greatest opportunity to plan their tax liabilities.** This is because:

- Tax planners charge highly for their services, which means that only the wealthiest can afford their fees. The result is that, inevitably, the

opportunity to 'minimise' tax liabilities in this way is restricted to limited groups in society. This almost certainly explains why in the UK, for example, the effective overall tax rate of the top decile of income earners in 2001-02 was 33.6 per cent, which was the lowest rate bar that for the third decile (32.7 per cent) and substantially below that for the bottom decile (53.3 per cent).<sup>122</sup>

- Tax planning almost always requires the person undertaking it to have cash or other resources which they do not need to use immediately. By definition this means that the person has wealth in excess of current needs, which is not the case for the vast majority of the world's population;
- The wealthiest members of society are the most mobile. Tax planning sometimes requires this;
- Capital is transient in its location, and easy to relocate. People find it much harder to move. Capital is owned by the wealthiest members of society.

3. **The self employed have more opportunities for tax planning than those who are employed.** The reasons are:

- In a majority of countries in the world the income of employed people is subject to tax at source i.e. before the tax payer receives payment. This means that the scope for tax planning is considerably reduced and any planning is undertaken with regard to investment income or in the claiming of expenses, of which there tend to be fewer allowed for employed people than the self employed;
- In contrast, self employed people usually pay their tax after calculating the profits arising from their activities

in self employment and this provides many more opportunities for determining what is to be considered income, and what expenses might be allowed. This means they can usually plan taxation liabilities due on the whole of their income, whether resulting from their own efforts or from investment sources. As such, at least some of the opportunities for planning already noted for corporations may also be available to the self employed. Since many such opportunities have an international dimension and most self employed people work only in the country in which they both reside and work, this limits the possibilities for legitimate use of those arrangements.

4. **Those with international links often have greatest opportunity to plan their tax affairs.** The reasons are:

- If a person is resident in more than one country it provides them with some opportunity to choose under which countries rules they will be taxed;
- If a person has family in more than one country it might provide opportunity to divert income to lower tax territories;
- As soon as more than one country is involved in any tax situation it becomes harder to obtain information to determine whether abuse is taking place, or not;
- Those who have employments in more than one country can split their income to ensure that part at least is subject to lower rates of tax. This is commonplace amongst internationally mobile people such as many business executives;
- The opportunity to flee is the ultimate way to avoid tax, especially as countries rarely cooperate

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<sup>122</sup> Hills, J *Inequality and the State* Oxford, 2004, page 168.

effectively in collecting tax debts due to each other.

## Ways to save tax

Against this background, the ways in which individuals can save tax include (but are by no means limited to) the following examples, which are generic and ignore the numerous opportunities each tax system offers for specific tax planning:

### 1. Failing to declare income.

This action is tax evasion and is, of course, illegal, but the practice is widespread. Recent studies in Sweden, which is one of the countries considered most tax compliant, suggest that on average self employed people in that country under-declare their income by 30 per cent<sup>123</sup>. A study in the UK has suggested a higher rate of non-declaration, with the true income for blue collar self-employed people being more than 100 percent greater than reported income, whereas true income for white-collar self-employed people exceeds reported income by 64 percent. This was based on 1992 data<sup>124</sup>. In the USA the 'tax gap' is suggested to be at least US\$300 billion a year<sup>125</sup>, although the split of this between evasion and avoidance is not known. This sum amounts to about 15 per

cent of anticipated tax revenues in the USA<sup>126</sup>.

Data on this loss in developing countries is not available. It is believed that the proportionate losses are likely to be higher. For example, *The Swazi Observer* reported on 16 January 2007 that the estimated tax gap (i.e. the difference between anticipated and actual tax revenues) in that country was 41 per cent<sup>127</sup>. Much of this was, however, alleged to be because of fraudulent practice by tax officials.

Whatever the cause, it is likely that tax evasion is the biggest single cause of revenue loss to tax authorities, and almost certainly exceeds the impact of tax avoidance by some way. Measures to tackle tax evasion are, therefore a matter of very high priority for any tax regime wishing to improve its efficiency of tax collection.

### 2. Moving income out of tax.

The practice will usually be akin to tax evasion, but may also on occasion be tax avoidance. The following practices are common:

- **Moving mobile capital offshore.** The result of this practice is that income arising from capital is not declared by the taxpayer to the tax authority to whom they have to report their income. In addition, the offshore territory is chosen to ensure that it has no duty to provide information with regard to income earned to the tax authority in the country in which the taxpayer is based.

123 Engström, P and Holmlund, B (2006); *Tax Evasion and Self-Employment in a High-Tax Country: Evidence from Sweden*; Upsalla University Department of Economics Working Paper 2006:12 downloaded from [http://www.nek.uu.se/Pdf/wp2006\\_12.pdf](http://www.nek.uu.se/Pdf/wp2006_12.pdf) 22-1-07

124 Lyssiotou, P, P Pashardes and T Stengos (2004), *Estimates of the Black Economy Based on Consumer Demand Approaches*, *Economic Journal* 114, 622-640.

125 <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> accessed 22-1-07

126 [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_facts-figures.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf) accessed 22-1-07

127 <http://www.observer.org.sz/main.asp?id=31499&Section=main> accessed 22-1-07

This practice is likely to be illegal for most taxpayers who undertake it. Nonetheless it is the basis of much of the offshore banking industry. Individuals who operate in this way frequently gain access to their money by using of an offshore debit or credit card. That card is used by the taxpayer in the country in which they live but is settled from a bank account located in the offshore territory in which the taxpayer is holding their funds to evade tax. The debit or credit card need not be held in the name of the person actually using it. Barclays Bank plc was subject to an order to disclose details of many of the offshore credit cards that it ran for UK resident people in 2006. This was in part because a sample survey showed that only 19 per cent of Barclay's customers with UK addresses and cards linked to international accounts made tax returns in the UK<sup>128</sup>. The UK's HM Revenue & Customs expected to recover at least £1.5 billion (US\$2.85 billion) as a result of this single enquiry<sup>129</sup>.

- **Disguising the source of income.** The process of moving income offshore may be assisted by moving the income of the individual into either an offshore trust or company. Very often an offshore company is used, but that is in turn owned by an offshore trust. To be even vaguely legal such an arrangement usually requires the person creating the trust to entirely forego any interest in the income arising from it. In practice the offshore finance industry deliberately ignores this requirement and assists

individuals to evade their tax obligations by creating sham arrangements which have the appearance of being trusts. Such arrangements give the appearance that the individual has foregone an interest in the arrangement, though in reality effective control is retained of the assets in question. For example, the British Channel Island of Jersey passed new trust laws in 2006 designed to facilitate the provision of such arrangements by local financial services providers. These are discussed in more depth in an appendix 5 to this report. The use of these arrangements, whilst entirely legal in Jersey (and other territories where they are commonplace) is likely to constitute tax evasion in the country of residence of the taxpayer making use of them.

- **The income due to a person is attributed to someone else.** For example, income of a parent is attributed to a child who might enjoy their own tax free allowance, or the income of one spouse may be attributed to a non-earning spouse so that they might use tax rates and allowances that might otherwise go unused. These arrangements are commonly used for investment income, where they can be hard to challenge on occasion, and as commonly by the self employed where significant anti-avoidance measures are needed to tackle artificial arrangements of this nature.
- **Income subject to one tax is re-categorised as having a different form which is subject to a different tax, or to no tax at all.** For example, income that should be subject to income tax is re-categorised so that it is subject to capital gains taxes, which are usually charged at lower rates. Many offshore financial

<sup>128</sup> [http://money.scotsman.com/scotsman/articles/articledisplay.jsp?article\\_id=3014506&section=Tax&prependForce=SM\\_XML](http://money.scotsman.com/scotsman/articles/articledisplay.jsp?article_id=3014506&section=Tax&prependForce=SM_XML) accessed 22-1-07

<sup>129</sup> *ibid*



services companies provide products to facilitate this objective<sup>130</sup>.

Alternatively, income that is derived from labour is re-categorised through the use of privately owned limited companies as investment income by way of payment of dividends to owners instead of the payment of wages to the same people for providing their labour. As a result social security charges are either avoided or evaded<sup>131</sup>.

- **The provision of benefits in kind.** This arrangement provides rewards other than cash to employees who are charged to tax at less than the value of the benefit provided as a result. Commonly provided benefits include company cars and insurance of various kinds, as well as pensions. It is highly likely that this practice falls firmly in the area of tax avoidance.
- **Payment by way of share options.** Use of share options to reward management and staff (with a particular emphasis in practice on management) has been commonplace during the period when maximising 'shareholder value' has been emphasised as the objective of management<sup>132</sup>. It is, unfortunately clear that the availability of such schemes in taxation law has not prevented abuse, which has most often happened by backdating share-

options so that their value can be maximised<sup>133</sup>. It is estimated that 160<sup>134</sup> major US companies are being investigated for abusing the use of stock options and that one in ten US company executives may have been involved in the practice<sup>135</sup>. Even when used legally these schemes have too often been subject to generous taxation treatment for both the company making payment of them and the recipient, including on occasion the avoidance of social security obligations on what is otherwise quite clearly labour income.

- **Payment through esoteric mediums.** Some quite incredible payment arrangements have been used to avoid tax and social security contributions, particularly on the earnings of highly paid executives. This practice has required massive anti-avoidance taxation provisions<sup>136</sup>.

### 3. Claiming expenses and allowances for which tax relief is not available.

Even if all income is declared it remains possible that a person may seek to reduce their tax liability by claiming tax deductions to which they are not entitled. Examples might include:

- **Claiming that expenses have been incurred for business purposes when**

130 See, for example, an explanation at <http://www.moneyextra.com/dictionary/rollup-funds-moneyextra-003659.html> accessed 22-1-07

131 For an explanation see, for example, <http://www.hmrc.gov.uk/ir35/> accessed 22-1-07.

132 For a brief explanation of shareholder value see [http://en.wikipedia.org/wiki/Shareholder\\_value#Shareholder\\_Value\\_Maximization](http://en.wikipedia.org/wiki/Shareholder_value#Shareholder_Value_Maximization) accessed 22-1-07

133 For an explanation see <http://www.macworld.com/news/2007/01/17/backdating/index.php?lsrc=mwtoprss> accessed 22-1-07

134 <http://news.independent.co.uk/business/news/article2112605.ece> accessed 22-1-07

135 <http://business.timesonline.co.uk/article/0,,13129-2209355,00.html> accessed 22-1-07

136 See, for example, <http://observer.guardian.co.uk/business/story/0,,1984272,00.html> accessed 22-1-07

in reality they were not. This form of tax evasion is rife and forms the basis of more tax enquiries by tax administrators around the world than probably any other issue, even though the absence of reported income probably gives rise to significantly more taxation loss. The normal practice is for private expenditure to be disguised as having been incurred for business purposes.

- Making claims for allowances that are not due.

The variety of these abuses depends upon the tax system of the country in which the taxpayer resides. In general, the more tax reliefs that are available and the more complex tax returns are, the more likely is abuse of this sort. The only effective counterbalance to such abuse is the threat of rigorous tax audit by authorities who have a range of penalties, including the threat of adverse publicity. Claims might however include:

- Allowances for children that do not exist;
- Claims to be married when that is not true;
- Claims for gifts to charities that have not taken place;
- Claims for pension contributions that have not been made;
- Deductions for costs such as those incurred for travelling or for education when such costs have not been incurred.

#### 4. The use of artificial arrangements

This practice is common in some jurisdictions, especially if tax is charged in accordance with the strict interpretation of the letter of the law and in accordance with the

contractual construction of financial arrangements. This is common, for example, in countries that use British law as the basis for their taxation arrangements.

The challenge posed by such arrangements is relatively straightforward to explain. A transaction is designed that complies with the form of the legislation i.e. the strict letter of the law is complied with. The spirit of the law is, however, abused. In other words the substance of the transaction does not comply with its form. Such arrangements are, for example, commonplace with regard to gift, inheritance or wealth taxes where it is claimed that a person has gifted an asset to another person but has, in practice, retained the benefit of the asset gifted for their own use. Other mechanisms frequently involve the use of trusts to engineer transactions which are favourable for tax though in reality little or no economic loss is suffered by the person making the claim for a tax deduction.

These schemes tend to be esoteric. They are often 'packaged' as though they are products. It was this practice that KPMG was found to be pursuing in the USA by the Senate Investigations committee. In a report to the US Senate in 2005<sup>137</sup> it was said that:

*The abusive tax shelters investigated by the Subcommittee were complex transactions used by corporations or individuals to obtain substantial tax benefits in a manner never intended by the Federal tax code. While some*

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137 Report 109-54 to the 109th Congress (2005) 'The Role Of Professional Firms In The U.S. Tax Shelter Industry' available at [http://levin.senate.gov/newsroom/supporting/2005/psi\\_taxshelterreport.GPOversion.041305.pdf](http://levin.senate.gov/newsroom/supporting/2005/psi_taxshelterreport.GPOversion.041305.pdf) accessed 22-1-07

*of these transactions may have complied with the literal language of specific tax provisions, they produced results that were unwarranted, unintended, or inconsistent with the overall structure or underlying policy of the Internal Revenue Code.*

*These transactions had no economic substance or business purpose other than to reduce taxes. Abusive tax shelters can be custom-designed for a single user or prepared as a generic tax product sold to multiple clients. The Subcommittee investigation focused on generic abusive tax shelters sold to multiple clients as opposed to a custom-tailored tax strategy sold to a single client.*

It was also noted that<sup>138</sup>:

*numerous respected members of the American business community were heavily involved in the development, marketing, and implementation of generic tax products whose principal objective was to reduce or eliminate a client's U.S. tax liability.*

In an earlier report to the US Senate it was noted that just four artificial schemes marketed by international accountants KPMG might have cost the US Treasury at least US\$7.2 billion<sup>139</sup>. It is clear that the cost of such arrangements is high.

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138 *ibid*, page 5

139 Report 108-34 to the 108th Congress (2003) '*U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals*, page 3 available at [http://www.senate.gov/~govt-aff/\\_files/sprt10834tax\\_shelters.pdf](http://www.senate.gov/~govt-aff/_files/sprt10834tax_shelters.pdf) accessed 22-1-07

## Chapter 6

# How governments don't help themselves

Many corporations and individuals make it their objective to save tax, either legally or illegally. It would seem obvious to presume that the governments of the world would make it their objective to ensure that they could not do this. In practice this often seems far from true. Both individually and collectively the governments of the world could do much to enhance their chances of collecting the tax due to them. This section deals with the problems that governments create to dealing with this problem. A later section suggests how they might be tackled.

### The issues

The following issues need to be addressed by most governments:

1. **A consistent approach to taxation needs to be adopted, and the idea that paying tax is a 'good thing' needs to be promoted.**

Far too often governments are as guilty as their citizens in promoting the idea that tax is a 'bad thing'. For example, the UK government's National Savings & Investment board (NS&I) promotes tax free saving on its website<sup>140</sup> using the following language:

*You can invest up to £93,000 tax-free with NS&I. You have worked hard for your*

*money...make it work harder for you. With no income tax to pay on the investments shown below, you get to keep all your returns.*

This approach makes no sense when governments wish to promote the notion that paying tax is a societal duty. In addition, it provides opportunity to those promoting offshore and other opportunities to say they are only providing an alternative to government promoted tax free savings schemes, whether that is true or not.

2. **The language of tax abuse needs to change.**

Tax evasion is a crime, and yet it is rarely depicted as such. There are at least three reasons for this. Firstly, it is not seen as being akin to money laundering, embezzlement or fraud when financial crime is being considered. It is as if abusing the property rights of a government is not seen as having the same status as abusing the property rights of individuals. This is not true. It is just as significant.

Secondly, corruption is currently defined by most governments using the definition promoted by Transparency International, which is<sup>141</sup>:

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140  
<http://www.nsandi.com/savingneeds/taxfreeinvestments.jsp> accessed 23-1-07

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141  
[http://www.transparency.org/news\\_room/fag/corruption\\_faq#faqcorr1](http://www.transparency.org/news_room/fag/corruption_faq#faqcorr1) accessed 23-1-07

*The misuse of entrusted power for private gain.*

The problems with this definition are:

- It focuses upon abuse by public employees and politicians, since that is presumed inherent in the term 'entrusted power';
- It ignores the fiduciary duty of company officials to their shareholders and stakeholders when they engage in tax abuse;
- It ignores individual abuse of the law for private gain by way of tax avoidance;
- It focuses upon those who perpetrate the abuse, but ignores the actions of those who facilitate that process by providing the mechanisms that make it possible e.g. by supplying offshore companies which are often used in such activities.

As a result insufficient attention to the issues of tax evasion as corruption and a disproportionate amount of attention is given to issues of corruption within government. The latter is important, but has to be seen in a broader context if attention is to be given to dealing with the problem.

Thirdly, the language used with regard to abuse of the tax system is frequently very different to that used with regard to the abuse of social security and other benefit systems. So, for example, the term 'tax evasion' is little understood, and most lay people cannot differentiate it from 'tax avoidance' and are unaware as to which is legal or illegal, or indeed if either is illegal. In contrast, the language used with regard to the abuse of state benefits is unambiguous although the amounts abused are usually much lower. For

example, the UK's Department of Work and pensions website says<sup>142</sup>:

*There are NO IFS, NO BUTS when it comes to benefit fraud. Deliberately withholding information that affects your claim is stealing. That's why we are targeting benefit thieves!*

This is undoubtedly true, but the same language is not used in taxation, where a much greater degree of tolerance is shown. This does not help governments tackle tax evasion or aggressive tax avoidance because it permits those who undertake such acts to believe that they are not treated seriously.

### **3. Transparency is not a clear part of the domestic agenda of many governments.**

Tax evasion is a crime that takes place under a veil of secrecy. That veil of secrecy can be provided by offshore structures, but need not be. Many countries do not require the filing on public record of the accounts of limited companies. Most allow the use of nominee directors, company secretaries or shareholders who disguise the real ownership and management of companies. Not all require key management documents such as the constitution of the company to be filed. And almost none require this information of trusts, though these are customarily used to provide de facto banking secrecy arrangements and to disguise the ownership of assets to make the payment of tax less likely.

For example, in November 2006 the United States Government Accountability Office reported<sup>143</sup> that:

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142  
<http://www.dwp.gov.uk/campaigns/benefit-thieves/> accessed 23-1-07

*Most states do not require ownership information at the time a company is formed, and while most states require corporations and limited liability companies (LLC) to file annual or biennial reports, few states require ownership information on these reports. With respect to the formation of LLCs, four states require some information on members, who are owners of the LLC. Some states require companies to list the names and addresses of directors, officers or managers on filings, but these persons may not own the company. Nearly all states screen company filings for statutorily required information, but none verify the identities of company officials.*

By providing these opportunities domestically it becomes much harder to ask for transparency from offshore territories.

#### **4. Many governments provide tax legislation that does, at least in part, mimic tax haven behaviour.**

For example:

- The UK's domicile rules provide a 'ring fence' for people not usually resident in the country meaning they may avoid much domestic taxation and taxation on all their income arising elsewhere in the world;
- The Netherlands, Belgium and Switzerland provide 'conduit' arrangements that abuse double tax treaties and allow dividends, royalties and other capital flows to move through those states with little or not tax being charged, often when on their way to a tax haven;

- Ireland offers artificially low tax rates to encourage the relocation of profits to be taxed there;
- Many developing countries offer tax holidays to companies undertaking direct foreign investment in their territory, which arrangements are little different to the forward tax agreements offered by many tax havens;
- New Zealand offers trust and other capital tax regimes to non-residents that emulate many tax haven schemes;
- Many countries offer banking secrecy, either by law, or by provision in the constitution, as is the case in Chile.

There is little prospect of tackling tax abuse effectively either domestically or internationally when this duality of approach is adopted by many governments. Unsurprisingly many citizens of the countries in question, and of other countries, doubt the commitment of governments offering such schemes to tackling tax abuse.

#### **5. Failing to make the tax base broad enough.**

Tax is collected as a percentage part of an agreed transaction value. Two factors therefore determine the likely yield of any tax. The first is the tax rate, the second the likely tax base - which is the technical term for the range of transactions it covers. If the tax base is too narrow e.g. because income of certain forms is excluded (or is subject to exemptions and holidays) or allowances are too great then even if tax rates seem reasonable the tax yield might be negligible or non-existent. This does, for example seem to be a problem in Ghana where the Extractive Industry

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143  
<http://www.gao.gov/new.items/d06376.pdf>,  
 page 1, accessed 23-1-07



Transparency Initiative Aggregators reported<sup>144</sup> in September 2006 that:

*Corporate tax is currently fixed at 25 per cent of Net Profit. All the mining companies under consideration are on self assessment.*

*The revenue accruing to the Government from the payment of corporate taxes by mining companies is very little. This situation arises as a consequence of i) accelerated depreciation and ii) the carry forward of losses concessions granted to mining companies operating in the country.*

Put simply, the definition of the taxation base for this tax means that almost no tax is paid. This is a technical issue which requires attention in Ghana, and many other countries.

Tax competition, as discussed in the earlier chapters of this report has had a significant impact in this area and has seriously reduced the effectiveness of the taxation systems of many developing countries. It has also resulted in degradation of the tax base of developed countries in particular areas e.g. the UK's shipping taxation laws based purely on tonnage operated bear little relationship to any charge on profit and are subject to significant criticism for that reason<sup>145</sup>.

## 6. Governments create too much complexity in tax legislation.

<sup>144</sup> Ministry of Finance And Economic Planning (Ghana Extractive Industries Transparency Initiative -Geiti) *Inception Report On The Aggregation Of Payments And Receipts Of Mining Benefits In Ghana*. September 2006. Prepared By: Boas & Associates

<sup>145</sup> For a consideration by the UK government of this obvious exercise in tax competition see [http://www.hmrc.gov.uk/consult\\_new/pir\\_tt.pdf](http://www.hmrc.gov.uk/consult_new/pir_tt.pdf) accessed 26-1-07

Tax is complex. Complex tax legislation is inevitable as a result. However, all rules provide opportunity for abuse and the greater the number of rules the more abuse there might be. Governments need to be aware of this and should be wary in using taxation law to:

- Micro-manage the economy e.g. by offering detailed exemptions or allowances for relatively small scale projects that then encourage abuse of the law;
- Create legislation without clarifying its intent so that Courts can be specific in their interpretation of its use;
- Create conflicting claims or rules e.g. by providing that one transaction be taxed in different ways for different taxes, such as income tax and national insurance;
- Provide incentive to adopt artificial structures e.g. by granting corporations or trusts tax rates that are substantially different from those paid by individuals on the same source of income;
- Unreasonably burden one form of income, such as that from employment, thus giving incentive to those seeking to re-categorise income as something subject to lower tax rates, such as investment income;
- Provide gaps in the range of income subject to tax. For example, whilst the yield from capital gains taxes are often low one of their major benefits is in ensuring that income is not re-categorised as a gain and so falls out of tax altogether;
- Design inappropriate tax schemes e.g. a system of indirect taxes when many of the business in the economy in question do not and could not keep the required records for the

administration of that tax, as has for example been found to be the case after the introduction of VAT in India, of which it has been reported that:

*VAT, to be successful, relies on voluntary tax compliance. Since VAT believes in self assessments, dealers are required to maintain proper records, issue tax invoices, file correct tax returns etc. The opposite seems to be happening in India. Businesses are still run on traditional lines. Cash transactions are order of the day. The unorganised sector dominates the market. The hope of higher tax compliance and lesser evasion is still a far cry in [the state of] Andhra Pradesh. This is reflected in the high percentage rate of return defaulters (14 per cent), a high percentage of credit returns (35 per cent) and a high percentage of nil returns (20 per cent). That is, roughly 70 per cent of VAT dealers are presently not paying any tax.*<sup>146</sup>

## 7. Governments fail to provide instruction to Courts on how to interpret tax legislation to prevent tax abuse.

In many countries a literal or 'legal' interpretation of the law is used when deciding how taxation legislation is to be interpreted by Courts. The alternative 'equitable' basis of interpretation is ignored, or is considered illegal. This appears to have its origins in a decision of the English courts in 1869 in which it was said<sup>147</sup>:

<sup>146</sup> [http://en.wikipedia.org/wiki/Value\\_added\\_tax](http://en.wikipedia.org/wiki/Value_added_tax) accessed 23-1-07

<sup>147</sup> *Partington v. Attorney-General* (1869), L.R. 4 E. & I. App. 100, per Lord Cairns at p. 122.

*If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute.*

It is difficult to see what justification there can still be for this legal construction when it so obviously creates injustice for all parties. Alternatives are available. For example, an Australian law of 1901<sup>148</sup> on legal interpretation said:

*In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.*

It may be argued that to ensure that tax legislation is 'fit for purpose' there would be considerable benefit in adopting this approach to the interpretation of taxation law. If that were to be the case then many of the constraints on government which are used by taxpayers to their advantage might be removed. In common law this includes reliance on what is called the Duke of Westminster principle, which might be summarised as:

*Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it*

<sup>148</sup> Section 15 AA of the Acts Interpretation Act, 1901 downloaded 4 December 2006 from [http://www.austlii.edu.au/au/legis/cth/consol\\_act/aia1901230/s15aa.html](http://www.austlii.edu.au/au/legis/cth/consol_act/aia1901230/s15aa.html) 23-1-07

*otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.*<sup>149</sup>

This philosophy underpins the tax planning industry, and is the biggest single issue that must be tackled if the problem of raising the revenues needed for development are to be solved.

#### 8. Governments are failing to adequately resource their taxation departments

This is a serious problem affecting governments the world over, but appears more common in developing than developed countries. Issues include:

- Failing to pay staff appropriately. This has two consequences:
  - § They are easily poached by professional firms who then put the training they have to use for the benefit of the private sector who are seeking to minimise tax paid;
  - § There is increased likelihood of corruption amongst tax officials. A recent report suggests that this sort of corruption is a major cause of the tax gap (the difference between expected tax receipts and sums actually received) in Swaziland<sup>150</sup>.

<sup>149</sup> IRC v. Duke of Westminster (1936) 19 TC 490, [1936] AC 1 quoted at [http://en.wikipedia.org/wiki/Tax\\_evasion](http://en.wikipedia.org/wiki/Tax_evasion) accessed 23-1-07

<sup>150</sup> <http://www.observer.org.sz/main.asp?id=31499&Section=main> accessed 22-1-07

- Failing to train staff. Tax staff need training in:
  - § Tax law;
  - § Accountancy;
  - § Commercial law and practice;
  - § Administration procedures;
  - § IT;
  - § Debt recovery;
  - § International law.

Such training is expensive and runs that risk that trained officials will be poached by professional firms willing to pay higher salaries.. The result is a skills shortage amongst tax officials the world over<sup>151</sup>.

There is also a resulting credibility issue. If taxpayers believe that tax authorities will not detect what they are doing then there is little incentive to get such things right.

#### 9. Failing to establish 'fit for purpose' administration systems

PricewaterhouseCoopers recently reported<sup>152</sup> on issues relating to paying tax around the world for the World Bank. There are various methodological problems in their work, but some observations do reflect what is happening in the real world. For example, PWC reports that:

<sup>151</sup> Anecdotal support for this view has been provided to the author from places as far apart as Greece, the UK, Kenya and Chile. All agree that the pressure of commercial salaries is an issue of concern with regard to retaining the best staff.

<sup>152</sup> PricewaterhouseCoopers 2006 'Paying Taxes - the Global Picture' available at [http://www.pwc.com/extweb/pwcpublication.s.nsf/docid/6FE224AC0BA720BB85257214004DA2E9/\\$file/paying\\_taxes.pdf](http://www.pwc.com/extweb/pwcpublication.s.nsf/docid/6FE224AC0BA720BB85257214004DA2E9/$file/paying_taxes.pdf) accessed 24-1-07

*Firms in 90 per cent of surveyed countries rank tax administration among the top five obstacles to doing business. In several - including Bangladesh, Cambodia, the Kyrgyz Republic, Russia and Uzbekistan - working with the tax bureaucracy is considered a bigger problem than tax rates*

The same report says:

*In Cameroon the average annual tax return for businesses is 172 pages, in Ukraine, 92 and in the United States, 64.*

The world wide average is 35. It is clear from the surveys that this split, with greatest complexity, number of payments required and overall tax rates to be found amongst developing and transitional economies, with smaller administration burdens in developed countries is a real one. But as the report noted:

*In several Eastern European countries simplification has not had the desired impact on perceived business obstacles, in part because it focused on income tax only.*

This finding is consistent with the findings of a report on flat taxes for the UK, which suggested that they would, if anything increase rather than reduce complexity in the tax system and could increase the opportunities for tax avoidance and evasion<sup>153</sup>.

#### 10. Failing to set appropriate tax rates.

If excessive administration imposes a burden on business, so do tax rates that are out of line with the expectation of the

communities on which they are charged. This is a difficult subject, and one on which it should be noted that evidence for the existence of favourable 'Laffer curve'<sup>154</sup>, effects is almost non-existent<sup>155</sup>. However, as Alex Cobham of Oxford University has noted<sup>156</sup>:

*Evidence-based analysis of the impact of tax competition has been somewhat scarce, however. A newly-published paper from the Central Bank of the Netherlands offers fresh insights into the ways in which increases in capital mobility have changed rates of corporate tax. Harry Garretsen and Jolanda Peters<sup>157</sup> analyse a sample of annual data on 19 high-income OECD countries from 1981-2001, and present three main findings.*

*First, they confirm the reality of tax competition: an increase of 1 per cent in capital mobility is associated with a reduction in the corporate tax rate of between one half and a third of one per cent.*

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154 See [http://en.wikipedia.org/wiki/Laffer\\_curve](http://en.wikipedia.org/wiki/Laffer_curve) accessed 24-1-07 for an explanation of the laffer curve.

155 Murphy, R 2006 'A flat tax for the UK? The implications of simplification' ACCA, London downloaded from <http://www.accaglobal.com/pubs/publicinter est/activities/research/publications/tech-ft-001.pdf> 24-1-07

156 Cobham, A 2006 'Capital mobility and the effects of tax competition' Tax Justice Focus, volume 2 number 4 available from [http://www.taxjustice.net/cms/upload/pdf/TJF\\_2-4\\_on-screen.pdf](http://www.taxjustice.net/cms/upload/pdf/TJF_2-4_on-screen.pdf) accessed 24-1-07

157 Garretsen, H and Peters, J., 2006, 'Capital mobility, agglomeration and corporate tax rates: Is the race to the bottom for real?', Netherlands Central Bank, Research Department DNB Working Papers 113 available from [http://www.dnb.nl/dnb/home/file/Working\\_per cent20Paper\\_per cent20113-2006\\_tcm13-85963.pdf](http://www.dnb.nl/dnb/home/file/Working_per cent20Paper_per cent20113-2006_tcm13-85963.pdf) accessed 24-1-07

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153 Murphy, R, 2006 'A flat tax for the UK? The implications of simplification' ACCA, London downloaded from <http://www.accaglobal.com/pubs/publicinter est/activities/research/publications/tech-ft-001.pdf> 24-1-07

*Their second result is that the behaviour of neighbouring countries is important – where neighbours maintain higher rates, the pressure to cut rates is lower. Tax competition may be a global phenomenon, but it is additionally effective at the local level.*

*The third result is that agglomeration effects matter. Larger – and hence more powerful – economies like the UK and Germany are better able to resist the pressures of tax competition.*

It is clear that some countries ignore this evidence. The result is that they set rates of tax that are out of line with near neighbours and as such lose revenues because of capital flight and tax evasion.

As Cobham concludes:

*more aggressive anti-avoidance measures and the removal of exemptions have in some cases allowed revenues to be maintained (in the short-term at least).*

#### **11. Failing to deal appropriately with local professional people.**

As Chris Davidson, Deputy Director, Business Customer Unit, HM Revenue & Customs in the UK has noted, the role of tax intermediaries is vital in tax management. He is heading the review of the work of tax intermediaries being undertaken on behalf of the OECD in progress during 2007<sup>158</sup>. He has said of the initial findings from that work<sup>159</sup>:

*The importance of the role tax intermediaries play in a tax system can be tested by answering a simple question: would compliance with tax laws improve*

*if intermediaries did not exist? We have not yet found any country where the answer to that question is yes. Across the whole range of taxpayers, taxes and circumstances, tax intermediaries help their clients to avoid errors and deter them from engaging in unlawful actions. So tax intermediaries are not part of the problem, they are part of the solution. The study must therefore reflect the positive role tax intermediaries play in tax administration and aim to identify strategies for strengthening the relationship between tax intermediaries and revenue bodies.*

This issue is a challenge for all tax authorities, particularly in developing countries where there might be fewer professional people: indeed there may not be enough to ensure that the benefits of the existence of such a grouping can be obtained. It is also difficult when those tax intermediaries work mainly for a limited range of large clients from whom they therefore have problems of being independent. Tax authorities have to work closely with professional bodies and individual tax intermediaries to overcome these problems.

#### **12. Failing to engage in information exchange, or to assist tax collection.**

The process of information exchange with other governments is time consuming. In addition, the process of assisting another government to collect taxation revenues due to it through the local debt and tax collection processes of another state takes time and effort, without the rewards being apparent.

All of these issues need to be recognised and acted upon if governments are to seriously address the issue of stemming the flood of capital flight and tax evasion.

<sup>158</sup> See <http://www.oecd.org/dataoecd/38/29/37415572.pdf> for details, accessed 24-1-07

<sup>159</sup> Davidson, C, 2007, *Tax Journal*, 22 January 2007 page 13

## Chapter 7

# The role of tax intermediaries

As has been noted in the previous chapter, a positive role for tax intermediaries is vital if an effective tax administration is to be established. Problems exist in achieving this objective.

The OECD think there are four categories of tax intermediary<sup>160</sup>:

- law firms;
- accounting firms;
- other tax advisers; and
- financial institutions such as banks, insurance companies and other providers of tax advice or tax driven investments and products.

In addition, any consideration of this issue has to encompass the role of representative organisations such as professional institutes, trade associations and so on.

It must be stressed that many of these organisations play a positive role in tax administration by helping taxpayers to avoid errors and to comply with the requirements imposed upon them by law. Without this positive contribution by some tax intermediaries tax revenue losses might well be greater than they are.

It must also be acknowledged that many do not play that positive role. For example, following the budget in the UK in March 2005 a spokesperson for Moore Stephens, an international firm of accountants said to a national newspaper:

*No matter what legislation is in place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken.*<sup>161</sup>

His firm subsequently issued a statement suggesting that the spokesperson:

*Strongly rebuts any suggestion that he would ever countenance breaking the law, and it was never his intention to suggest that others should do so.*

In two sentences, however, the spokesperson had encapsulated what many professional people seek to do, and see as their role. It is this part of the tax intermediaries market that creates problems for any tax administration and does, in the process, encourage both capital flight and tax evasion. Some of the methods used to do this are explored below.

### 1. Aggressive tax planning.

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160 Davidson, C, 2007, *Tax Journal*, 22 January 2007 page 13

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161 *The Guardian*, 18 March 2005, <http://www.guardian.co.uk/business/story/0,3604,1171759,00.html>



Accountants frequently say that tax planning falls into one of two categories. The first is tax evasion, which is illegal. The second is tax avoidance, which is legal. They say the distinction is clear, and unambiguous and so long as they are tax avoiding and not evading then anything they do is legal. The precedents for this vary from tax jurisdiction to jurisdiction, but many countries in the world (and a majority of the significant tax havens) use English law as the basis for much of their tax decision making. The Duke of Westminster case noted in the previous chapter provided one legal basis for this view. Another is that of Lord Clyde who said in 1929 in the House of Lords<sup>162</sup> that:

*No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.*

It should be noted that not everyone agrees. Lord Templeman also said in the House of Lords<sup>163</sup> in 1993 that:

*In common with my predecessors I regard tax avoidance schemes of the kind invented and implemented in the present case as no better than attempts to cheat the Revenue.*

Perhaps it is not surprising in consequence that Denis Healey, a former Chancellor of the Exchequer in the UK said<sup>164</sup>:

*The difference between tax avoidance and tax evasion is the thickness of a prison wall.*

It is actually more complicated than any of the views represented. The law is, in any country constructed of words and words are always open to different interpretations, both at a point in time and over time (with there being no requirement that the law as applied take account of the use of words at the time it was created). It is this uncertainty which tax avoidance (sometimes called 'aggressive' tax avoidance<sup>165</sup> to differentiate it from the legal activity which the TJN calls tax compliance) seeks to exploit.

The TJN seeks to differentiate the two activities by using the terms as verbs, and not as nouns. This is possible if the terms describe approaches to the management of taxation, and not the specific transactions that result from that activity. In other words, the test of acceptability of a transaction is primarily an *ex ante* rather than *ex post* test. This contrasts with almost universal current legal practice where investigation is *ex post* i.e. outcomes are all that matter.

Using this understanding:

- Persons who evade tax seeks to limit their liability to pay tax by what they know to be criminal means;
- Persons who avoid tax seeks to minimise their liability to tax by any means believed possible, even if it is apparent that the law of one or more

162 Ayrshire Pullman Motor Services and Ritchie v. IRC (1929) 14 TC 754

163 IRC v. Fitzwilliam (1993) 67 TC at 756 (UK)

164 Quoted at [http://en.wikipedia.org/wiki/Tax\\_evasion](http://en.wikipedia.org/wiki/Tax_evasion) accessed 24-1-07. The original date of this comment has never been determined.

165 See for example comments attributed to Dave Hartnett at HM Revenue & Customs in the UK at <http://www.accountancyage.com/accountancyage/analysis/2144683/taxman-gets-tough> accessed 24-1-07

states may be abused in the process, but without criminal liability arising;

- Persons who are tax compliant seek to settle their tax liability (but no more than that sum) in the location where it can be best determined to be due, at the time when it is likely that a legislature wished it to be paid and only after claiming those deductions and reliefs which it is clear were meant to be provided given the economic substance of the transactions undertaken by the taxpayer.

Using this definition it is also apparent that the person avoiding tax is seeking to avoid the obligations imposed by law, even if that law is not broken as a result. This makes the meaning of the term more accessible.

Most accountants reject this view. A general opinion might be that of David Clegg, a tax partner in Ernst & Young, South Africa who said in 2006<sup>166</sup> on behalf of his firm that:

*It is my view that morality has no place in the application of tax law since morality is largely subjective. Where it has a place, is in the writing of tax law in such a way that it is both clear and equitable, within the context of its tax raising purpose.*

This explains why accountants and other tax intermediaries will use any loophole available to reduce tax whatever the ethical constraint others might think applicable, and indeed are pressurised to do so by their insurers for fear that if

they do not they might be liable for tax they have not saved their clients<sup>167</sup>.

It is notable that in an unpublished review of the Codes of Ethics of professional institutes governing tax intermediaries the TJN was unable to find any that condemned tax avoidance or aggressive tax avoidance.

## 2. The sale of 'tax products'.

Tax products are a particular form of tax planning, where an opportunity for tax abuse is identified and then sold by a tax adviser. The most notable case is that of the sale of tax products by KPMG referred to in Chapter 3 of this report. Other firms were also found to be heavily involved in such activities. The report of the US senate committee looking at these issues said (page 9)<sup>168</sup>:

*The investigation found that numerous respected members of the American business community had been heavily involved in the development, marketing, and implementation of generic tax products whose objective was not to achieve a specific business or economic purpose, but to reduce or eliminate a client's U.S. tax liability.*

*By 2003, dubious tax shelter sales were no longer the province of shady, fly-by-night companies with limited resources.*

167 For a discussion of this duty by the head of tax at PricewaterhouseCoopers UK see <http://www.pwc.com/uk/eng/ins-sol/publ/tax/Rcollier-keyword.pdf> accessed 24-1-07 and especially the discussion of *Slattery v Moore Stephens* [2003] STC 1379 where a firm of accountants was found liable for not advising a client to use an offshore tax arrangement.

168 Report 109-54 to the 109th Congress (2005) 'The Role Of Professional Firms In The U.S. Tax Shelter Industry' available at <http://levin.senate.gov/newsroom/supporting/2005/psi.taxshelterreport.GPOversion.041305.pdf> accessed 22-1-07

166 [http://www.ey.com/global/content.nsf/South\\_Africa/20\\_Jun\\_06\\_The\\_morality\\_of\\_taxation](http://www.ey.com/global/content.nsf/South_Africa/20_Jun_06_The_morality_of_taxation) accessed 24-1-07

*They had become big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms, law firms, investment advisory firms, and banks.*

Some tax authorities, such as those in the USA and UK have responded to these arrangements by requiring the registration of tax planning schemes<sup>169</sup>. This has made them aware sooner of what is happening, and so allowed them to prevent the use of abusive tax planning schemes. However, as the UK has found, some tax advisers refuse to cooperate with such arrangements even if required to do so by law<sup>170</sup>.

### 3. Non-disclosure by professional firms.

All tax authorities have limited resources to investigate the tax returns submitted to them. Some tax intermediaries exploit this by submitting tax returns in which they do not draw attention to areas of doubt in the returns they have made. As a result they gamble on the tax authority in question not investigating the return they have made. The risk they impose on their client varies depending upon the action they have taken prior to submitting the return:

- If the client in question has taken legal advice on the plausibility of the tax planning that is inherent in the return being legal prior to submission taking place then it is commonplace for there to be almost no risk to the

taxpayer from such non-disclosure. The legal enquiry has made their actions appear legal, even if subsequently transpires on enquiry or in Court that this is not true. As such the most risk that they face is payment of the tax found to be due and interest upon it. This practice is commonplace amongst MNCs and is considered a small price to pay for the tax advantages won. This practice explain why research has found that many MNCs restate their tax liabilities downwards in years subsequent to those when estimates of the liability were first made<sup>171</sup>.

- If legal advice on the tax planning scheme used has not been taken in advance, or claim is simply made for expenses of dubious validity to the business then the risk arising on enquiry increases. Penalties are usually due for the non-payment of tax on a return shown to be wrong in this case. However, these penalties are considered the gamble that non-disclosure justifies.

Although full disclosure is claimed to be the approach used by many professional firms anecdotal evidence supplied to the author suggests that even when this is the declared policy of a firm it is rare that this is true until enquiry arises. Few make disclosure in the first instance on the basis of 'all cards being face up on the table'<sup>172</sup>.

### 4. Creating artificial structures in which taxpayers save tax.

<sup>169</sup> See for example <http://www.hmrc.gov.uk/ria/disclosure-guidance.pdf> accessed 24-1-07

<sup>170</sup> See <http://www.accountancyage.com/accountancyage/analysis/2172908/hmrc-beefing-disclosure-changes> accessed 24-1-07

<sup>171</sup> See [http://www.taxjustice.net/cms/upload/pdf/Mind\\_the\\_Tax\\_Gap\\_-\\_final\\_-\\_15\\_Jan\\_2006.pdf](http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_final_-_15_Jan_2006.pdf) accessed 24-1-07 page 25

<sup>172</sup> For discussion of this concept see <http://www.taxresearch.org.uk/Blog/2006/08/01/ethics-test-for-tax-planning/>. A similar logic is explored in Davidson, C, 2007, *Tax Journal*, London 22 January 2007

It appears commonplace for tax intermediaries to create structures which mean that tax payers do not pay tax. As Senator Carl Levin has said<sup>173</sup> of this activity:

*Most are so complex that they are MEGOs - meaning "My Eyes Glaze Over." Those who cook up these concoctions count on their complexity to escape scrutiny and public ire.*

As Senator Levin also made clear<sup>174</sup>:

*Tax shelters are complex transactions with no economic substance other than to provide individuals and corporations with large tax benefits unintended by the tax code.*

To explain this it is important to note that most of these arrangements fall into one of two groups:

- a. The structure is created within a group of companies. That means that whilst a series of complex transactions might take place, quite possibly spread over several jurisdictions, the reality is that no property or cash really changed ownership since all the companies involved were under common ownership. These arrangements are also very hard to spot. Group accounts presented as the corporate reports of major multi-national entities exclude all intra-group transactions from the report for the precise reason that they do not add value by way of involving third party exchange. These arrangements are, however, those that MNCs seek to

exploit. Transactions placed in such structures might include the following, all of which are explained in more detail in chapter 2:

- Transfer pricing, where multiple stages are added to what might otherwise be a straightforward exchange;
- Thin capitalisation where the benefits of loan finance are shifted into low tax territories, with tax relief on interest paid being taken in relatively high tax territories;
- Licensing arrangements where intellectual property is relocated to low tax territories (where it is highly unlikely to have been created) with tax accumulating in that low tax territory as a result<sup>175, 176</sup>;
- Tax arbitrage and structured finance<sup>177</sup>;
- Double dipping;

175 Research suggests that up to 97 per cent of the retained profits of computer maker Apple might be located in Ireland for this reason. See <http://www.taxresearch.org.uk/Blog/2006/07/17/apple-does-a-microsoft-and-goes-for-secrecy-in-ireland/> accessed 24-1-07

176 Another example of 'creative' licensing was to be found in the case of KPMG's structuring of a licencing arrangement within the WorldCom group (before its bankruptcy) under which no less than US\$20 billion was paid from high tax to low tax states for the benefit of group companies in high tax states having access to 'management foresight'. See [http://www.fenews.com/fen37/law\\_and\\_fe/aw\\_and\\_fe.html](http://www.fenews.com/fen37/law_and_fe/aw_and_fe.html) accessed 24-1-07 for more information.

177 For discussion of one such deal involving US and UK banks see [http://www.taxjustice.net/cms/upload/pdf/WSJ\\_Border\\_Crossing\\_-\\_Glenn\\_Simpson\\_-\\_30\\_JUN\\_2006.pdf](http://www.taxjustice.net/cms/upload/pdf/WSJ_Border_Crossing_-_Glenn_Simpson_-_30_JUN_2006.pdf). The author of this chapter participated in the research of that article for the *Wall Street Journal*.

173 <http://www.senate.gov/~levin/issues/index4.cfm?MainIssue=BudgetTaxesandtheEconomy&SubIssue=AbusiveTaxShelters> accessed 24-1-07.

174 *ibid*

- Creation of 'orphan companies' to hide the liabilities of a company off its balance sheet, an arrangement which usually involves potential abuse of charitable principles.
- b. The structure is created for a private company or for an individual. In this case the arrangement is very likely to involve an offshore structure. Options include:
- Setting up offshore trusts;
  - Setting up offshore companies to assist the taxpayer to hide their identity or the source of their income, or to avoid obligations e.g. those arising under the EU Savings Tax Directive which apply to individuals but not to companies<sup>178</sup>;
  - Arranging for the 're-invoicing' of international transactions<sup>179</sup>;
  - Creating an offshore pension arrangement<sup>180</sup>;
  - Providing offshore debit or credit card payment facilities so that the remission of offshore funds to a persons country of residence cannot be traced<sup>181</sup>;
  - Splitting employment contracts. This arrangement is common in countries with unusual residence rules, such as the UK, where offshore income is not taxed if not remitted to the country of residence if the recipient is not a long term or habitual resident of the country in which they live. In that case if they work internationally part of their salary is paid offshore for their 'overseas' work and only part is subject to tax in the country of residence. This arrangement has, for example, been very popular with bankers in the City of London, where bonuses were expected to reach £19 billion in 2006<sup>182</sup>. It is likely that at least part of these were paid offshore to avoid tax.

## 5. Supporting the credibility of the offshore world.

There is little doubt that the largest firms of accountants and lawyers working in the offshore world do their best to steer clear of illegal practices. It is equally clear that some less reputable firms promote the sale of services which whilst themselves legal do assist those who wish to evade tax, launder money or undertake criminal activities related to drugs, slavery and other wholly abusive activities. It is not by chance that almost any story of international crime or corruption has an offshore element to it.

The presence in tax havens of international banks and accountants serves to legitimise the offshore world. As

<sup>178</sup> For a competent explanation see [http://en.wikipedia.org/wiki/European\\_Union\\_withholding\\_tax](http://en.wikipedia.org/wiki/European_Union_withholding_tax) accessed 25-1-07

<sup>179</sup> For an example of a company that claims to offer 're-invoicing' services (which are a blatant form of transfer pricing abuse) see <http://www.offshoreinc.net/reinvoicing.html> accessed 24-1-07

<sup>180</sup> An example of such an arrangement which does, however, have few of the characteristics many would think should be found in a pension arrangement can be found at <http://www.closepb.com/Trust/pension/index.htm> accessed 25-1-07

<sup>181</sup> A candid description of the uses to which such cards can be put can be found at

<http://www.ptclub.com/offshorecreditcard.html> accessed 25-1-07

<sup>182</sup> <http://www.guardian.co.uk/executivepay/story/0,,1851785,00.html> accessed 25-1-07

appendix 3 shows, these firms operate quite extensively in the offshore and tax haven space.

Appendix 3 was work undertaken specifically for the purposes of this report. The TJN identified 72 tax havens in its 2005 publication *tax us if you can*. It may be possible to now delete both Nauru and Niue from that list<sup>183</sup>. Brunei and Ras al Kaimah on the other hand might be added<sup>184</sup>. The list is, however, for practical purposes complete.

Unsurprisingly the largest firms of accountants all operate in the major financial centres that provide as many opportunities for tax leakage as do the major havens, which is why they are on the list. What is more interesting is their concentration in those centres more readily recognised as havens, of which there are 63 in all, but of which 18 are considered insignificant because of their limited impact. This leaves 45 active havens.

KPMG's website says they work in 38 of these havens. An alternative test, undertaken using the Google search engine found their presence in 41 of them. Similar searches for the other big four firms found:

- PricewaterhouseCoopers (PWC) admitting to their presence in 25 havens but appearing to have a presence in 38;
- Ernest & Young admitting to a presence in 38 havens, but with only 37 of these being capable of confirmation by search engine testing;

<sup>183</sup> Jason Sharman in 'The Future of Offshore' 2007 (forthcoming) suggests both have ceased to operate as havens.

<sup>184</sup> Ibid, and *Tax Justice Focus*, Volume 2, no.3

- Deloitte admitting to a presence in 29 havens whilst apparently working in 33 according to search havens.

All testing was done in the week ending 26 January 2007.

Perhaps unsurprisingly all the firms were present in all the major havens. What was not anticipated was the surprising reluctance of three of these firms to acknowledge their operations in the mid range, and especially the minor havens. PWC in particular appear not to acknowledge their activities in all the minor havens in which they seem to have a presence on their web site.

In January 2007 Loughlin Hickey, worldwide head of tax at KPMG said<sup>185</sup>:

*I want to highlight signs that tax and corporate governance is an emerging issue, it is a global issue, and it is likely to set new standards for transparency in tax across the whole world.*

In practice, however, the largest firms of accountants in the world operate in locations where opaqueness and not transparency is the hallmark of trade, taxation and regulation. Until the leading firms change their attitude towards working in these locations, or are seen to be publicly demanding changes in the standards of transparency which operate in the offshore world, the new standards of transparency outlined by Loughlin Hickey will not happen.

## 6. Supporting tax competition.

Tax competition is not a naturally occurring phenomenon. It has been promoted by those who benefit from it.

<sup>185</sup> <http://www.kpmg.co.uk/news/detail.cfm?pr=2788> accessed 26-1-07



Most especially it has been promoted by accountants acting in what they perceive to be their own interests and those of their clients.

The large firms of accountants have been major exponents of tax competition. Take, for example, the following extract from a press release issued by KPMG Canada in November 2006:

*New research covering 86 countries, including Canada, has confirmed that low corporate tax rates can help to give a country a significant competitive advantage over economic rivals, and are connected with higher than average economic growth.*

*But the advantage tends to be short term and has to be backed up with a good legal and economic infrastructure and targeted incentives if countries are to attract long term private sector investment.*

*This conclusion comes from a study by KPMG International, which analyses international movements in corporate tax rates for the past 14 years, drawing on the annual surveys the organization has conducted since 1993.*

*The findings point to the economic growth enjoyed over this period by countries like Ireland, Norway, Sweden, and Denmark, and draws a parallel between this success and a favorable corporate tax regime. The outstanding example has been Ireland.*

The position is unambiguous: KPMG support tax competition. The presence of all these firms in the significant tax havens of the world is the clearest evidence of that belief.

The same sort of message comes out of the professional institutes of accountants. For example, Chas Roy-

Chowdhury, head of tax at the Association of Chartered Certified Accountants, which has members throughout the world, has made presentations which unambiguously highlight the cases of Ireland and Singapore as locations that bring benefits from low taxes<sup>186</sup>.

## 7. Failing to provide an appropriate lead.

The difficulties which the largest firms have encountered in keeping their own tax practices legal or ethically acceptable are well documented<sup>187</sup>. The most comprehensive review of this issue is to be found in *The Role of Accountancy Firms in Tax Avoidance: Some Evidence and Issues* by Prem Sikka of the University of Essex, UK and Mark P. Hampton, University of Kent, UK. The reader is recommended to read that paper for a fuller insight into this issue<sup>188</sup>.

What is clear is that the failure of the accounting firm Andersens only highlighted a malaise which is commonplace throughout the largest firms of accountants. Whilst there have been substantial statements made about new management systems and compliance amongst these firms what is also true is that their offshore activities continue, and their revenues continue to rise, not least for taxation services. In 2005/06 the top 50 firms of accountants

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186 See for example <http://www.ceccar.ro/b/ro/pp13.pdf>

187 See for example, 'Race to the Bottom: The Case of the Accountancy Firms' by Jim Cousins MP, Austin Mitchell MP and Professor Prem Sikka (University of Essex) available from <http://visar.csustan.edu/aaba/RacetothetBottom.pdf> accessed 26-1-07

188 Available from [http://www.essex.ac.uk/AFM/research/workipg\\_papers/WP05-03.pdf](http://www.essex.ac.uk/AFM/research/workipg_papers/WP05-03.pdf) accessed 28-1-07

in the UK saw their tax fees rise by more than 8.5 per cent to just short of £2 billion (US\$3.8 billion) whilst an estimate by the TJN - based on the published results of the Big 4 accountancy firms - suggests their combined total taxation fees exceeds US\$16 billion.

Nor have the problems gone away. On 26 January 2007 it was reported that in a court hearing in Texas, USA:

*KPMG admitted that through the actions of former partners and employees it prepared fraudulent tax returns for clients; drafted false statements to support the tax shelters; issued opinions that were false; concealed the tax shelters and the facts regarding them from the Internal Revenue Service; failed to locate and produce documents sought by the IRS, and misrepresented to the IRS KPMG's role in creating the tax shelters.*

What was significant was that the offences continued until 2002 i.e. well after the time that these issues were first noted. As Dennis Howlett, who runs what is probably the best read accounting blog, noted<sup>189</sup>:

*It doesn't matter which way KPMG attempts to spin this or divert attention away, the extent and number of admitted offences spells out one thing: systematic law breaking that continued after the original offences were committed.*

*I know there is a large majority of professionals who see tax avoidance as a business cost. But when set out in these stark terms, it is hard to understand how advisors can justify that position when they must know they're attempting to*

*manipulate the law for advantage. I can't understand that logic.*

The point is well made. Firms earning the level of fees indicated have a duty to show leadership in tax compliance and even if their past misdemeanours are behind them, whilst these firms continue to promote tax competition and the secrecy spaces that allow it to take place it is not clear that they are doing so.

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189  
<http://www.accmanpro.com/2007/01/27/kpmg-admits-96-tax-violations/> accessed 28-1-07

## Chapter 8

# The role of the tax havens

### Where is the tax haven world<sup>190</sup>?

There are more than seventy tax havens in the world. Those recognised by the TJN in its publication *tax us if you can*<sup>191</sup> are used as the basis for Appendix 3 to this report. To this list can be added Brunei, Ras al Khaimah, (and for the brave Anjouan<sup>192</sup>). A number, shown as 'notional havens' might be deleted because it is likely that very little activity takes place there even if they have tax haven characteristics.

It is important to note that the terms 'tax haven' and 'offshore' are often used interchangeably, but it would be entirely mistaken to think that the places involved are all small, palm-lined islands. Many are major financial centres, such as London and New York. What characterises the offshore world of tax is not where it is, but what happens there.

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190 The widely acknowledged best introduction to the subject is *'The Offshore World'*, Ronen Palan, Cornell University Press, 2003. A more descriptive approach is taken by William Brittain-Catlin in *'Offshore: The Dark Side of the Global Economy'* Farrar Strauss and Giroux, 2005. Perhaps the most rigorous review of the reaction of the tax havens to attempts to regulate them is *'Havens in a Storm'*, J C Sharman, Cornell University Press, 2006.

191 Available from [http://www.taxjustice.net/cms/front\\_content.php?idcat=30](http://www.taxjustice.net/cms/front_content.php?idcat=30) accessed 30-01-07

192 Sharman, J, *'The Future of Offshore'* 2007 (forthcoming)

### What characterises a tax haven?

The OECD defined 'harmful preferential tax regimes' (which might otherwise be considered to be those undertaken by a tax haven) as having the following key features<sup>193</sup>:

- i) *No or low effective tax rates*
- ii) *"Ring-Fencing" of Regimes*
- iii) *Lack of transparency*
- iv) *Lack of effective exchange of information*

Other factors the OECD considers relevant are:

- v) *An artificial definition of the tax base*
- vi) *Failure to adhere to international transfer pricing principles*
- vii) *Foreign source income exempt from residence country tax*
- viii) *Negotiable tax rate or tax base*
- ix) *Existence of secrecy provisions*
- x) *Access to a wide network of tax treaties*
- xi) *Regimes which are promoted as tax minimisation vehicles*
- xii) *The regime encourages purely tax-driven operations or arrangements*

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193 OECD, *'Harmful Tax Competition – an Emerging Global Issue'*, OECD, Paris, 1998

These are useful indicators. What they mean in practice is:

1. **Secrecy.** The primary product of the tax haven is secrecy. This secrecy usually extends to:
  - a. Banking secrecy, or if that is not available the ability to hide the ownership of a bank account behind trustees;
  - b. The ownership, management and constitutional details of companies;
  - c. The accounts of companies in full or in part;
  - d. All trust arrangements.
2. **Use of nominees.** The use of nominee arrangements is allowed to ensure that whatever information is required to be filed on public record, and sometimes even with relevant authorities, can be anonymised. The presence of professional or other people who are willing to accept payment for the provision of nominee services is, of course, a necessary requirement in this case, but one where supply is rarely found to be lacking;
3. **Limited or no information exchange on request being made from tax or other authorities in other countries, even if a criminal offence is being investigated<sup>194</sup>.** It has to be noted that this situation has improved recently as a result of bilateral agreements between many tax havens and the USA and agreements between those engaged in the EU STD

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<sup>194</sup> Comprehensive information on information exchange is available from the OECD. See 'Towards a Level Playing Field' published as the '2006 Assessment by the Global Forum on Taxation'

and EU member states. But, bilateral agreements have limited impact and the scope of exchange allowed under these agreements is still decidedly limited in many cases.

In addition, it is worth noting that these exchange arrangements tend to be with the major economic powers in the world. As has been noted by the Chile<sup>195</sup>:

*In 2004 Chilean tax authorities contacted 34 jurisdictions [from the OECD 'blacklist'] requesting cooperation with tax authorities on the same basis as the OECD. Of the 34 jurisdictions contacted, only ten bothered to respond and of these only five were willing to exchange information. What is evident is that individual or isolated actions will not reduce the problem.*

The message is clear, only multilateral approaches to information exchange can solve this issue and ensure that information is available to all those who require it, and most especially in developing countries.

4. **Low or no taxes.** This is the one area where the 'race to the bottom' can truly be said be happening. Some territories such as Cayman have long offered no direct taxation. Others, such as Jersey, Guernsey and Isle of Man, who have in the past offered rates (largely at the choosing of the taxpayer) of between 0 and 20 per cent are now moving to 0 per cent corporate taxation. The trend is everywhere downward for corporate tax rates as the havens seek to outdo

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<sup>195</sup> Concept Paper on Tax Havens - A contribution prepared by the GT-7 / Chile for the Technical Group Gt-7 Meeting January 10-11, 2007 Santiago, Chile

each other (which they do, without concern for their well-being as a group, this being the one and only area where it can be said that states do compete in the world).

The same can also be said of personal taxation. It is generally true that tax havens do not charge those using their services to tax on capital gains, wealth, gifts or inheritances. In addition they offer either no income taxes or more commonly low or capped tax rates to those claiming to reside there. Switzerland pioneered capped tax payments in the 1930s. The idea is now being copied by the Isle of Man (which is also extending it to its banking sector, which will be the only corporate activity taxed there soon) and Jersey and Guernsey are looking to follow suit.

As worryingly, the same situation can be reproduced in major financial centres, such as the UK. The UK's 'domicile laws'<sup>196</sup> mean that any person with a country of origin other than the UK, or with a parent with such a country of origin may claim to live in the UK but have intention to eventually leave. In that case they are only taxed on their income arising in the UK and income arising outside the UK when and if it is remitted to the UK. This encourages people in this situation to accumulate their assets offshore. This is a blatant and abusive tax practice as bad as many seen in the more conventional havens. It is unsurprising that the list of the richest people in the UK has a

significant number included who are in a position to use this law<sup>197</sup>.

5. **The availability of structures designed to exploit these opportunities and professional service providers who facilitate their use.** These structures and their use are noted in more detail later in this chapter.
6. **A charade of activity.** So significant is this issue that it forms the next section of this chapter.

### The offshore charade

According to LowTax.Net<sup>198</sup> the following businesses are most commonly located offshore:

- trade marketing and distribution;
- financial holding and investment activities;
- corporate financial and management services;
- offshore banking;
- offshore financial services;
- ship management;
- licensing and franchising royalty collection;
- professional services;
- insurance.

It is clear that most of these are administering activities undertaken

<sup>196</sup> See <http://www.hmrc.gov.uk/pdfs/ir20.htm#domicile> accessed 31-1-07 for an explanation

<sup>197</sup> <http://www.timesonline.co.uk/section/0,,2108,00.html>

<sup>198</sup> A web site that promotes offshore activity <http://www.lowtax.net/lowtax/html/obruses.html> accessed 31-1-07

somewhere else or are providing services to those who are doing so.

The reality is that almost nothing happens 'offshore'. Offshore is a charade where activities are recorded as taking place although they actually happen elsewhere. So, and for example:

- a. The £187 billion of funds held in Jersey in September 2006<sup>199</sup> were not really located there. A population of about 90,000 people undertaking almost no genuine capital intensive entrepreneurial activity could not generate a meaningful return on that sum, which amounts to more than £2 million per head. They do not need to. The cash is actually on the London money markets and merely 'booked' as being held in accounts in Jersey. This can, of course, only happen because the UK allows payment of interest to Jersey without tax being deducted at source, this being the complicity of the major financial centres in these arrangements.
- b. There is no evidence of the development of trade marks and licences offshore. Nor is there any sign that a major university or research facility has ever developed major technological breakthroughs in the locations where many patents are located for tax purposes. The management of these assets offshore is an artificial activity. The development of the licensed property happened elsewhere.

A good example might be the recently much publicised relocation

of Bono's recording rights to a Netherlands based tax structure. These rights were not created in the territory in which they are now located. Their relocation there is an artificial legal exercise. It is, however important to note again that a major financial centre acting as a haven, in this case the Netherlands, is facilitating this by setting tax rates as low as 5 per cent on royalty income.

- c. The 'professional services' provided offshore are frequently a charade. For example, in common law trustees are meant to be responsible for managing the assets they control. However, in jurisdictions like Jersey arrangements are being created to ensure that trustees are pure nominees for persons who buy their services to present the appearance of a trust being in existence. In reality, however, no such arrangement has been created and the assets remain under the control of the owner, who remains located elsewhere. For details see appendix 5. It should be noted that whilst the practices involved may be entirely legal in Jersey, the establishment of trusts in such locations by persons who can still secure the benefit of the income arising to the 'trust' is only legal if that income is declared on the settlor's tax return in the country where that person is ordinarily resident.

The charade described in appendix 5 is designed to ensure they need not make such declaration but if the financial services provider knows that this is happening their assistance in making such arrangements will be the facilitation of tax evasion, and that is money laundering and so criminal, even in those locations. This is why the rules on looking through these types of activity have to be changed

<sup>199</sup>  
[http://www.jerseyfinance.je/\\_support/uploadedFiles/Quarterly per cent20report per cent20for per cent20period per cent20ended per cent2030th per cent20September per cent202006 per cent20- per cent20Final.pdf](http://www.jerseyfinance.je/_support/uploadedFiles/Quarterly%20report%20for%20period%20ended%2030th%20September%202006%20-%20Final.pdf)  
accessed 31-1-07



so that they are assumed to take place 'onshore'.

A discussion of the issues regarding the creation of offshore trusts in the Isle of Man and the problems that flowed from these for the users of those arrangements can be found on the Tax Research UK blog<sup>200</sup>.

- d. The offshore operations of many MNCs are also a charade. For example, many such companies seek to locate their group finance functions in tax havens to exploit tax advantages and, maybe, thin capitalisation arrangements as described in chapter 4. However as Jim Stewart of Trinity College, Dublin has shown<sup>201</sup>, in the period 1998-2003 treasury management firms located in the Dublin Financial Services Centre owned by MNCs located outside Ireland had high financial flows and declared high profits as a per cent of revenues but *median employment is zero*. In other words, these companies did not actually undertake their activities in Ireland. It was a legal fiction that allowed them to book their profits in this location. Effective management control must have been elsewhere as there was no one to do it in Ireland. This is why the rules on corporate residence have to be changed so that this fiction can no longer be abused.

### Offshore: not what it claims to be

The idea that assets are located 'offshore' is a convenient fiction. It is

<sup>200</sup>  
<http://www.taxresearch.org.uk/Blog/2007/01/04/trust-me-im-a-trust-company/>

<sup>201</sup>  
<http://www.taxresearch.org.uk/Documents/JimStewart2006.pdf>

untrue, as noted, that assets are really located in such places, but there is another step that needs to be understood in this process. The offshore locations also deny that the assets are located in their territories.

The law of Jersey might help demonstrate this. As Richard Murphy noted in his report to a States of Jersey Scrutiny Committee in June 2005<sup>202</sup> when discussing the concept of tax residence in Jersey's taxation law:

*The "make believe" world of Jersey [is] apparent. In section 123 (1) a company is resident in Jersey if "its business is managed and controlled in the Island" but in section 123 (A) (9) "the office of director of an exempt company shall be deemed not to be an office exercised within the Island". It is, of course, the case that the directors of a company manage and control it. That is their job. As such if the directors are in Jersey or meet in Jersey all common sense says that directors working in Jersey make a company resident there. This is the common standard of tax law in places that are not tax havens. But section 123 (A) (9) says otherwise in the case of Jersey.*

In fact, the key word here is 'deemed'. Of course Jersey knows that companies using this arrangement are by all normal tax management standards located in Jersey. It suits them to suggest otherwise. What they never choose to ask is the obvious follow on question, which is 'if the company is not located in Jersey, where is it?' Again, the reason is obvious. They know that the answer is 'nowhere' purely because of the fiction they have created, but that is not an issue they wish to address. The result is,

<sup>202</sup> See page 12  
<http://www.taxresearch.org.uk/Documents/4180-12935-2962005.pdf> accessed 31-1-07

however, that for tax purposes these companies are indeed 'nowhere'.

There is a second dimension to this issue. As awareness of the risk of information exchange has arisen in the offshore world, measures have been taken to limit its effectiveness. Perhaps the most worrying is the creation of 'cell companies' and the ability of offshore companies to entirely relocate themselves between countries, leaving no trace of themselves in their previous country of location.

Protected Cell Companies (PCC) were first provided by Guernsey in 1997<sup>203</sup>. That territory has a specialisation in the provision of offshore re-insurance arrangements. In effect a PCC operates as if it were a group of separate companies except all are part of the same legal entity. There is, therefore a 'parent level' which provides management services for the company but in addition there are a number of further segregated parts called cells. Each cell is legally independent and separate from the others, as well as from the 'parent level' of the company.

As has been noted<sup>204</sup>:

*The undertakings of one cell have no bearing on the other cells. Each cell is identified by a unique name, and the assets, liabilities and activities of each cell are ring-fenced from the others.*

*If one cell becomes insolvent, creditors only have recourse to the assets of that particular cell and not to any other.*

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203 [http://www.legalinfo-panama.com/articulos/articulos\\_41a.htm](http://www.legalinfo-panama.com/articulos/articulos_41a.htm) accessed 31-1-07

204 [http://www.offshore-fox.com/offshore-corporations/offshore\\_corporations\\_030404.html](http://www.offshore-fox.com/offshore-corporations/offshore_corporations_030404.html) accessed 31-1-07

This use in insurance terms is worrying. Anyone insuring with such an entity cannot be sure what assets might be used to cover their risk. No doubt that is the intent of those using them. More worrying though is their further possible use, of which some are now becoming aware<sup>205</sup>:

*The astute offshore practitioner can employ an offshore protected cell company as an effective asset protector and privacy enhancer.*

*With an offshore insurance corporation, it is market practice that provides tangible benefits; with the protected cell company, it is the structure of the entity itself -- think of a house with a locked front door, and rooms inside, each with a separate lock and key.*

*Protected Cell companies have -- in concert with other entities -- been used to construct what has been called "an impenetrable wall" against creditors and prying eyes. Whilst these claims can only be tested by time, this novel use of a PCC for asset protection and financial privacy is an interesting approach and a valuable piece of intellectual property.*

This is the logic of offshore: professional people use legislatures to create structures that they can sell to those wishing for secrecy, the only realistic use for which is the evasion of obligations arising under the laws of other countries.

Guernsey is no longer alone in supplying these companies. They are now becoming commonplace. Information exchange arrangements will have to take them into account.

Information exchange has no doubt motivated interest in companies being able to relocate themselves. Most territories take time to reply to enquiries

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205 *ibid*

on information exchange. Corporate relocation often takes less time than it takes an offshore tax authority to deal with an information request. As such relocation is an obvious flight strategy in the event of enquiry talking place.

Corporate relocation (or redomiciliation, or again redomiciliation, no one seems sure which is correct) is allowed by the laws of many offshore territories<sup>206</sup>. Malta, The Netherlands Antilles, many of the Caribbean havens and the Isle of Man now allow these arrangements, as do some Swiss cantons. The danger is obvious. Capital flight becomes corporate flight with the world populated by roving, unaccountable companies whilst the havens are held hostage to lowest common denominator practices for fear that those located there will leave. This effectively means that realistic attacks on offshore have now to be focussed on the suppliers of offshore services and the facilities that these companies use as much as on the companies themselves.

## The services offshore supplies

The arrangements that characterise offshore territories have been noted above. The products they supply include the following:

1. **International Business Companies (IBCs) or Corporations.** These are limited companies registered offshore. They are characterised by:
  - a. Secrecy as to ownership;
  - b. No requirement to file accounts, or even on occasion to keep books and records;

<sup>206</sup> For an example of an agent supplying this service see <http://www.alphaibc.com/content/view/44/94/> accessed 31-1-07.

- c. Little or no local tax liability in the company of incorporation on any transaction of any sort;
- d. No requirement to have local officers;
- e. Possible exclusion from being owned by local people in the country of incorporation;
- f. May be able to issue bearer shares, meaning ownership is in practice not recorded, although this activity is now diminishing;
- g. Unlimited powers to trade without regulation.

This is probably the most common offshore entity. The British Virgin Islands is the largest supplier<sup>207</sup>. There were 707,000 IBCs based in the BVI in 2005, a number increasing at the rate of almost 60,000 a year<sup>208</sup>. That is over 30 companies for every local person<sup>209</sup>.

2. **Trusts.** The nature of a trust is explained in appendix 5<sup>210</sup>. The key characteristic of an offshore trust is that:

- a. The settlor is frequently not named or a nominee is used to disguise the relationship between the settlor and the property;

<sup>207</sup> For details on BVI companies see <http://www.offshorebvi.com/bvi-offshore-companies.php> accessed 31-1-07

<sup>208</sup> <http://www.bvifsc.vg/DesktopModules/Bring2mind/DMX/Download.aspx?EntryId=136&PortalId=2&DownloadMethod=attachment> accessed 31-1-07

<sup>209</sup> Population data from <https://www.cia.gov/cia/publications/factbook/geos/vi.html>

<sup>210</sup> See also [http://en.wikipedia.org/wiki/Trust\\_\(property\)](http://en.wikipedia.org/wiki/Trust_(property)) accessed 31-1-07

- b. The trustees are usually nominees who will do whatever the settlor instructs;
- c. The trust deed does not specify the real purpose of the trust (which often states the purpose to be for the benefit of a charity or such other activity as the trustees think fit, providing unlimited scope for action and abuse)<sup>211</sup>;
- d. A side letter of wishes is issued to the trustees which states the real wishes of the settlor but need not be disclosed on enquiry;
- e. An enforcer is appointed to whom the trustees may turn for instruction if anything is to happen to the settlor.

The result is predictable. These arrangements are not trusts at all but are means to disguise the ownership of assets. It is important to note that this may not be just for tax reasons. People may wish to hide assets from their spouses, family or business partners. They may also be seeking to avoid inheritance laws. Some may be seeking to avoid regulation e.g. on controlling too large a part of an industry. Tax is, however, a common motivator for this action. In all cases the trust is almost certainly a charade or sham.

- 3. **Offshore credit card services.** This issue is discussed in depth in chapter 5, but is commonly provided to use funds held in an IBC which in turn is

owned by an offshore trust (sometimes in a different territory) to place as many obstacles as possible in the way of enquiry into beneficial ownership<sup>212</sup>.

- 4. **Offshore 'wrappers'.** The EU Savings Tax Directive (EUSTD) was introduced to target funds held by EU residents in tax havens on which interest earned was not being declared. Unfortunately its use is severely restricted due to it not applying to funds held in trusts (as a result of the opposition of the UK) and any limited company, onshore or offshore. In addition it only applies to cash based products. If however these are based inside insurance products then that cash is itself also outside the scope of the EUSTD. Such reactions to regulation are common offshore<sup>213</sup>.

- 5. **Reinsurance.** Reinsurance is the process by which an insurer (or a large entity that self insures) pays premiums to another company to share its risk. If paid to an offshore re-insurance company, where the premium is received tax free and accumulates tax free there is a special benefit for the company paying the premium: it gets tax relief on the payment but does not get taxed on its receipt offshore if it happens to also own the offshore reinsurance company. This becomes, in effect, another form of transfer pricing which is open to abuse.

211 As example see [http://www.lorne-house.com/pdf/Trust\\_Services\\_CONFIDENTIAL\\_QUESTIONNAIRE.pdf](http://www.lorne-house.com/pdf/Trust_Services_CONFIDENTIAL_QUESTIONNAIRE.pdf) which suggests the nomination of the UK's Royal National Lifeboat Institution for this purpose, a role in tax planning which it probably did not anticipate. This abuse of charities is common in this area.

212 An anonymous Mastercard is advertised at <http://www.offshoreexplorer.com/cards.php> accessed 31-1-07.

213 An example of a product targeted for this specific use made available by the Danish Jyske Bank can be found at [http://www.jyskebank.com/2.0\\_products/2.6\\_2\\_insurance\\_wrappers.asp?slangID=uk](http://www.jyskebank.com/2.0_products/2.6_2_insurance_wrappers.asp?slangID=uk) accessed 31-1-07

6. **Re-invoicing.** This abusive practice, which is commonly associated with capital flight and tax evasion is discussed in chapter 7.
7. **Hedge fund management.** At the end of 2004 it was estimated that 55 per cent of all hedge funds were registered offshore<sup>214</sup>. Hedge funds are recognised as a major source of risk in the current world financial architecture. By locating offshore many of these funds are virtually unregulated, increasing that risk, and untaxed, meaning they are unlikely to be accountable to the society that they might threaten by their actions. This is an area requiring significant research. The degree to which these funds are actually managed onshore whilst being registered offshore is unknown.
8. **Private equity finance.** Private equity finance is a broad description covering investment in shares not quoted on a stock market. The market is believed to have grown by 20 per cent in 2005<sup>215</sup>. It is estimated that companies that have received private equity funding account for the employment of around 2.8 million people in the UK, equivalent to 19 per cent of UK private sector employees.

Private equity is characterised by investing in existing and not new entities. It seeks to exploit these assets, usually by fierce cost cutting, and then sells the companies on to make a capital gain.

<sup>214</sup> [http://en.wikipedia.org/wiki/Hedge\\_fund](http://en.wikipedia.org/wiki/Hedge_fund) accessed 31-1-07

<sup>215</sup> [http://en.wikipedia.org/wiki/Private\\_equity#Size\\_of\\_industry](http://en.wikipedia.org/wiki/Private_equity#Size_of_industry) accessed 31-1-07

Much of the private equity market is at least nominally registered offshore. The attractions are little or no tax, especially on capital gains, an absence of regulation on investment management and, possibly, an absence of regulation on the approach these companies use to management of their assets. Relative anonymity, for example, helps those seeking to adopt an aggressive approach to staff.

Other services are supplied, such as on-line gambling, but these are not usually directly tax related.

### How much is offshore?

An estimate of the funds held offshore has been provided in chapter 3. What is clear is that the offshore world is continuing to grow. The number of companies in the British Virgin Islands is one indication of that. Another is provided by the table below showing the external positions of banks in some major tax havens. That level of exposure is increasing.

### The future of offshore

So far the various initiatives to restrict the activities of the offshore world have not in any way impacted upon its use. It is clear that a different approach is now needed if this issue is to be tackled effectively. The veils of secrecy need to be stripped away, not only through information exchange agreements – as has been the focus of the OECD's work in recent years – but more generally by requiring disclosure of beneficial ownerships, and by enforcing greater financial and legal transparency. This logic is inherent in the recommendations we make in the following chapter.

Table 1: External Positions of Banks - Assets in USD Billions

External Positions of Banks, Assets in Billions of US Dollars					
	2001	2002	2003	2004	2005
	US\$Bns	US\$Bns	US\$Bns	US\$Bns	US\$Bns
Guernsey	112	114	122	135	142
Jersey	169	245	284	307	360
Isle of Man	34	44	49	59	62
Cayman	823	1,015	1,039	947	1,216
Switzerland	711	805	850	921	966
Total	3,850	4,224	4,346	4,373	4,752
(Compiled from BIS Quarterly Reports, September 2002 A8; June 2005 page A8; June 2006 A8)					
From: The Future of Offshore, J.C. Sharman, 2007					



## Section 3: Closing the Floodgates

### Chapter 9 The Next Steps

All that is required to tackle the related problems of capital flight and tax evasion is political will. Although the focus of this paper might appear to be on developing countries and tax havens, many of the recommendations made in this paper relate also to the tax and legal regimes of countries in Europe and North America, some of which countries are stoutly resistant to attempts to strengthen international cooperation on tax matters, and some of which are wholly wedded to the notion of tax competition.

This reality is reflected in the recommendations made here, though this need not necessarily be an obstacle to progress. Much can be achieved within a national context: indeed a significant number of our recommendations can be undertaken by a country acting unilaterally. In many ways this is the starting point for change: few countries are completely free of the problems mentioned in this report and some of our recommendations will require domestic legislation as a part of their resolution.

Previous initiatives to tackle the related problems of capital flight and tax evasion have not begun with this perspective. The OECD initiative on harmful tax

competition launched in 1998<sup>216</sup>, the EU Code of Conduct on Business Taxation launched in 1997<sup>217</sup> and the EU Savings Tax Directive<sup>218</sup> all have a feature in common; they address a problem which is assumed to be 'elsewhere'. Of course that is true. This problem does exist 'elsewhere'. But in the same manner that the TJN seeks to change perceptions on corruption<sup>219</sup>, we also seek to change perceptions on this issue. And the new perception that is required is that tackling the issues relating to tax evasion requires changes in domestic practice as the first necessary step that has to be taken if others are to be asked to follow the lead of those now willing to act.

We have set out our recommendations under 4 headings:

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216 Available for download at <http://www.oecd.org/dataoecd/33/0/1904176.pdf> accessed 26-1-07

217 Available for download at [http://ec.europa.eu/taxation\\_customs/resources/documents/COC\\_EN.pdf](http://ec.europa.eu/taxation_customs/resources/documents/COC_EN.pdf) accessed 26-1-07

218 See [http://ec.europa.eu/taxation\\_customs/taxation/personal\\_tax/savings\\_tax/rules\\_applicable/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/rules_applicable/index_en.htm) accessed 26-1-07

219 See two papers by John Christensen: [http://www.taxjustice.net/cms/upload/pdf/Follow\\_the\\_Money\\_-\\_RGS-IBG\\_final\\_31-AUG-2006.pdf](http://www.taxjustice.net/cms/upload/pdf/Follow_the_Money_-_RGS-IBG_final_31-AUG-2006.pdf) accessed 26-1-07 and [http://www.taxjustice4africa.net/cms/upload/pdf/Mirror\\_Mirror\\_On\\_the\\_Wall\\_-\\_10\\_JAN\\_2007.pdf](http://www.taxjustice4africa.net/cms/upload/pdf/Mirror_Mirror_On_the_Wall_-_10_JAN_2007.pdf) accessed 26-1-07

1. Domestic changes;
2. International changes;
3. Changes to be undertaken as part of the development agenda;
4. The promotion of research to facilitate these changes.

Each is considered in turn.

## Domestic changes

The process of change requires progress on these issues at a domestic level:

### 1. Using the language of tax justice

It is easy for any attack on tax avoidance, evasion, corruption or capital flight to be represented as:

- an attack on business, or
- the addition of another regulatory burden on enterprise, or
- as a restriction of the rights of the individual.

But this misrepresents our agenda, which is focussed on justice for all people. This, however, has to be carefully managed if the right impression is to be given. The TJN has learned this from its own experience of dealing with havens, business and the lobby groups that represent them.

This is precisely why we now make clear what we support when explaining our work, rather than what we oppose. It is easy to be derailed when you are opposed to tax havens or tax competition. There are some serious lobbies only too willing to defend both, and they have the ear of the media and serious financial sponsors within the business community.

It is much harder to be derailed when promoting tax cooperation or transparency, for example.

It is therefore vital that the language used when discussing these issues is positive, because that reflects the benefits. What is actually at stake is the credibility of markets, the future of democratic government's right to tax those to whom they are responsible and the well being of the vast majority of the people of the world. Being positive about that objective is vital if these issues are to be addressed.

### 2. Redefining corruption

The weaknesses of current perceptions of corruption have been discussed elsewhere in this report and are further elaborated on in a paper by John Christensen attached as an appendix to this report.

Any country can choose to broaden the focus of debate on corruption from the 'demand side', which is the sole focus of attention within the Transparency International definition as used by the World Bank to the 'supply side' which includes:

- The activities of governments who supply the secret spaces in which corruption can take place, which include (but by no means exclusively) those jurisdictions categorised as tax havens;
- The facilitators who encourage and enable corrupt practices by aiding and abetting dirty money flows. This includes the bankers, lawyers, accountants and trust companies who set up and operate the enabling financial structures;
- Those who undertake illicit transactions related to capital flight and tax abuse both internationally and domestically;

- Those who ignore such transactions in the course of their duties.

These activities have to be tackled as strongly as does the use of those services. Only by using this dual track approach will this problem be effectively tackled. Until it is developing countries are being unreasonably penalised for the involvement of some in their governments in corruption whilst those who facilitate their activities remain unidentified and unpunished.

Furthermore, until our understanding of what constitutes corruption is broadened in this way, the loss of taxation revenues from developed countries because of tax corruption facilitated by places such as Luxembourg, Switzerland, the UK and the US will be more readily tolerated by society. This cannot be ignored any longer.

To tackle this issue governments need to show increased commitment to international agencies and their work in tackling corruption, but must at the same time seek to change the way in which corrupt practices are perceived by those agencies.

### 3. Putting transparency onto the domestic agenda

Transparency needs to be assertively placed on the policy agendas of both national governments and the multilateral agencies. In most countries there are significant weaknesses in this respect.

There is no company, charity, trust or other entity in the world that is not run by people. With the exception of charities it is commonplace for those people associated with it by ownership or another form of legal entitlement to be the major

beneficiaries of its activities. However, in many parts of the world:

- The ownership of companies need not be disclosed or can be disguised through the use of nominees;
- The names of those who manage companies, charities, trusts and other entities need not be disclosed or the true identity of those fulfilling those roles can be disguised through the use of nominees;
- In the event that a corporation, charity, trust or other entity is controlled by another of such concerns, the ultimate ownership of the entity and how that association is made is not disclosed.

This has the consequence of making accountability for many transactions hard to prove, and liability to taxation difficult to determine.

A commitment to improve transparency would require governments to:

1. Create a public register of companies and to record on it:
  - a. A list of all incorporated companies;
  - b. Detailed information for each company concerning:
    - i. Its registered office at which official contact can be made with it;
    - ii. Its constitution;
    - iii. Its membership and their identifiable addresses at which they can be contacted, updated at least annually, and if those members are nominees or corporations the names of the persons for whom they ultimately act shall be given;

- iv. The details of the person or persons (whether individuals or a corporation charity trust or other entity) that controls the corporation shall be stated and if there are 5 or fewer connected persons<sup>220</sup> who ultimately control the corporation then the means of establishing control shall be shown and the country of location for each individual, corporation, charity, trust or other entity involved in that process of control shall be disclosed, in each case with an identifiable contact address being given;
  - v. Its directors or other officers and if such persons are nominees the identities of those on whose instructions they are required or are accustomed to act, including the country in which such persons are located and the reasons by which they obtain their authority to issue instruction, in each case with an identifiable contact address being given;
  - vi. The holders of any debt or other financial instruments that it has issued which does, or might foreseeably, afford control of the company, including full details of beneficial ownership if nominees are used.
  - c. A list of all companies, charities, trusts or other entities controlled directly or indirectly by the company, in each case with sufficient identification details and an address being given so that the entity can be identified in its country of incorporation or registration.
  - d. Its annual financial statements.
2. Create a register of charities containing all that information required of companies, with in this case provisions with regard to directors and other officers extending to trustees and other such officials and with the addition that in this case:
    - a. The names of those promoting the charity;
    - b. The names and identifiable addresses of any individual, corporation, charity, trust or other entity who, with their connected parties, provides more than 10 per cent of the income of the charity in a year;
    - c. The names of the beneficiaries receiving more than 5 per cent of the income of the charity in any year;
    - d. The reason why the income of the charity has not been distributed annually if less than 75 per cent of its income has been applied to its stated charitable purpose.
  3. Create a register of trusts containing all that information required of companies, with in this case provisions with regard to directors and other officers extending to trustees and other such officials and with the addition that in this case:

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220 A connected person is generally considered to be a person's parent, step-parent, sibling, step-sibling, child, step child or greater issue or step-issue, aunt or uncle, first cousin, spouse and former spouses for a period of five years from the time of divorce having taken place and those spouses' connected persons and all corporations, trusts, charities or other entities owned or controlled by such persons, all business partners and those of connected persons and all trustees, nominees and agents appointed to undertake business on behalf of any such connected party, whether the person in question be a natural person or a corporation, charity, trust or other entity created under legislative powers anywhere in the world.

- a. The name of the settlor or settlors of the trust shall be disclosed and all those contributing a sum more than 10 per cent of previously gifted trust property shall likewise be disclosed together with their identifiable addresses, at least annually;
  - b. The trust deed shall be disclosed as shall all side letters, letters of wishes and other communications of any form (including written summaries of verbal instructions or communications issued in non-reproducible electronic format) that give indication to the trustees or those who instruct the trustees as to the way in which the funds under their care should be used;
  - c. In the event that the trust shall be of a discretionary nature then a list of all those who have benefited from more than 5 per cent of the income of the trust in any year in the previous ten years shall be supplied with identifiable addresses.
4. Create a register of all other containing all that information required of companies, and with such other information as shall be appropriate to ensure that information of the type required for charities and trusts is also available, if appropriate.

Each of these registers should be available for free public searching, on the internet and at public buildings at any time.

Such a commitment would require an extension of disclosure rules for almost every government in the world. The advantages would be:

- A reduction in secrecy;
- An increase in the efficiency of identifying assets under the control of any person or other entity;
- An increase in the tax yield;
- Greater openness and transparency in commercial transactions leading to benefits for all stakeholder groups including enforcement agencies of all sorts, employees, those with environmental concern, commercial creditors of organisations, banks and other suppliers of capital, consumers, and civil society at large.

It should also be noted that the requirements are, in practice not onerous. Under the 'know your client rules'<sup>221</sup> that are an integral part of the financial services culture and which are expected to be in operation in all states monitored by the Financial Action Task Force<sup>222</sup> or the IMF<sup>223</sup> such information has to be secured as a matter of course together with the additional information noted as to proof of ultimate beneficial ownership and the means by which such connections can be established. As such the public disclosure of this information should not impose an onerous administrative burden on any business which is in possession of a bank account anywhere in the world since the information must be available already.

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221 For a discussion of 'know your client' rules in general see [http://en.wikipedia.org/wiki/Know\\_your\\_customer](http://en.wikipedia.org/wiki/Know_your_customer) accessed 28-1-07.

222 For details on the FATF see [http://www.fatf-gafi.org/pages/0,2966,en\\_32250379\\_32236846\\_1\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/pages/0,2966,en_32250379_32236846_1_1_1_1_1,00.html) accessed 28-1-07

223 See, for example, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=17047> accessed 28-1-07

#### 4. Changing domestic tax laws to remove 'tax haven' or 'harmful' elements.

The OECD has defined harmful tax practices of the type it tended to associate with tax havens as follows<sup>224</sup>:

- i) *No or low effective tax rates*
- ii) *"Ring-Fencing" of Regimes*
- iii) *Lack of transparency*
- iv) *Lack of effective exchange of information*

Other factors the OECD thinks indicate such practices include:

- v) *An artificial definition of the tax base*
- vi) *Failure to adhere to international transfer pricing principles*
- vii) *Foreign source income exempt from residence country tax*
- viii) *Negotiable tax rate or tax base*
- ix) *Existence of secrecy provisions*
- x) *Access to a wide network of tax treaties*
- xi) *Regimes which are promoted as tax minimisation vehicles*
- xii) *The regime encourages purely tax-driven operations or arrangements.*

The EU found more than 120 such practices in member states when it began reviewing harmful tax practices affecting business taxation in accordance with its Code of Conduct on Business Taxation<sup>225</sup>. It found a further 85 in dependent and

overseas territories (mainly but not solely of the UK) for which the EU member states were responsible, including their tax havens. Not all of these have been eliminated as yet, although progress is being made. It is vital to note, however, that these issues related only to business taxation. It is likely that a greater part of this abuse is by individuals. As such this review has to be extended to all taxes to be effective, and it is highly likely that most countries will have actions to take when that is done, as the EU found with business taxation. Of course, those countries that have not done this review for business taxes need to cover that issue as well, now.

#### 5. Requiring all tax planning to be disclosed to tax authorities

No one can seriously dispute the need for firms to engage in tax planning. However, tax authorities do have a duty to ensure that:

- a. The practices used are legal;
- b. The proposed planning is not harmful to the wellbeing of the state.

In addition the tax authorities also need to know who has used them and how they have been used.

For this reason the UK, USA and some other countries require the advance disclosure of material tax planning to taxation authorities. Material is in this sense defined either by the value of the service supplied by the tax intermediary or with reference to the type of transaction proposed. The intention of disclosure regimes has been made clear by the UK's HM Revenue & Customs who have said<sup>226</sup>:

<sup>224</sup> OECD, 'Harmful Tax Competition - an Emerging Global Issue', OECD, Paris, 1998

<sup>225</sup> See [http://ec.europa.eu/taxation\\_customs/resources/documents/primarolo\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/primarolo_en.pdf) accessed 28-1-07

<sup>226</sup> <http://www.hmrc.gov.uk/ria/disclosure-guidance.pdf> page 11 accessed 28-1-07



*On its own the disclosure of a tax arrangement has no effect on the tax position of any person who uses it. However, a disclosed tax arrangement may be rendered ineffective by Parliament, possibly with retrospective effect.*

It is recommended that all governments adopt arrangements of this sort, and put in place penalty regimes covering:

- a. Failure to comply;
- b. Sourcing from offshore;
- c. Schemes which a taxpayer claims to have generated for their own use.

## **6. Requiring all tax accounting to be disclosed to tax authorities**

Full disclosure of all relevant information to a tax authority is vital. This is the basis for a relationship of trust, which is fundamental in taxation. It is, however, equally important that the same information is disclosed to all taxation authorities affected by a transaction. This is of particular importance within groups of companies. The benefits are:

- a. Reduced compliance costs due to increased confidence in the disclosures made;
- b. Increased probability of speedy dispute resolution on issues such as transfer pricing;
- c. Reduced risk for the taxpayer as a consequence of the enhanced certainty which this disclosure will bring;
- d. The reallocation of resources by management to more productive activity than the management of its taxation affairs;
- e. Lower administration costs because of the transparency of the information supplied.

It is often forgotten that groups of companies are not taxed. The individual companies that make up the group are taxed. Likewise an individual and the entities they control, be they companies, trusts, partnerships or whatever are not taxed as one; they are taxed as separate entities. It is, therefore, relatively easy for a group of companies or for an individual operating through a wide range of different entities, typically spread across a variety of different countries, to supply quite different information to different tax authorities about two or more sides of one transaction where these are in fact related, e.g. by way of transfer pricing.

This practice is unacceptable. Agreement to taxation affairs secured by way of differing disclosures means that there has been a failure to place all cards 'face up on the table' simultaneously. This is tantamount to non-disclosure and could constitute tax evasion. As such countries should seek to ensure that consistent information is supplied to all countries affected by the trading of a group. It is suggested that this would entail disclosure of the following data, all of which would, however be available to the Group, and no doubt to its auditors since without it being available it is unlikely that they could form a true and fair view of its taxation affairs:

### **1. Group structure**

- a. Parents
- b. Subsidiaries
- c. Associates
- d. Investment holdings
- e. Related parties

### **2. Individual company accounting**

- a. Turnover
  - i. Third party
  - ii. Group

- b. Expenses
  - i. Third party
  - ii. Group
  - iii. Highlight tax sensitive items
- c. Stock (Inventory)
  - i. Opening and closing data
  - ii. Inter group profit contained in valuation, opening and closing data
- d. Labour costs
  - i. Salary
  - ii. Social security
  - iii. Pensions
- e. Licence fees and royalties
  - i. Third party
  - ii. Group
- f. Interest payable
  - i. Third party
  - ii. Group
- g. Fixed asset costs
  - i. Depreciation
  - ii. Amortisation
  - iii. Profit or loss on disposal
  - iv. Inter group transfers
- h. Provisions
  - i. By type
  - ii. Reconciliation of balance sheet movement
- i. Currency exchange differences
  - i. Third party
  - ii. Inter group
  - iii. On consolidation
  - iv. Reconciliation of balance sheet effect
- j. Directors fees
- k. Management charges
  - i. Third party
  - ii. Group
- l. Profit pre tax
  - i. Arising from third party transactions
  - ii. Profits to be eliminated from consolidation on inter group transactions
- m. Tax
  - i. Current tax charge and all calculations and accounting entries supporting it
  - ii. Prior year adjustments to tax charge
  - iii. Reconciliation of taxable and accounting profits
  - iv. Tax paid and reconciliation of the payment with cash flow data either published or used in the group consolidated cash flow statement
  - v. Deferred tax charge
  - vi. Reconciliation of opening and closing deferred tax liability
- n. Income or expenditure not recognised in the profit and loss account
  - i. Movements in reserves
  - ii. Charges made in the statement of recognised gains and losses

### 3. Group accounting

- a. Details of the group consolidation
  - i. Details of any company excluded from the consolidation, and why
  - ii. Reconciliation of the reported financial statements of each subsidiary prior to and

after the application  
of consolidation  
journals to declared  
Group profit

- b. Overview by country
  - i. Turnover intra group and third party
  - ii. Third party expenditure
  - iii. Inter group expenditure
  - iv. Labour costs
  - v. Interest costs, third party and intra-group
  - vi. Other provisions
  - vii. Profit reported in financial statements
  - viii. Profit included in the group financial statements

It is stressed that this list is indicative, not prescriptive. A country would need to adapt the required disclosure to suit its particular circumstances.

It is clear, however, that obtaining this information would require (as indicated in section 3, parts l and m) the disclosure of a company and group's own tax accounting. Few countries have access to this data at present, and the ability of groups to account for tax without having to disclose what they are doing is a major weakness in most of the world's taxation law. This lack of accounting transparency provides a 'secrecy' space equivalent to the offshore world, the two combining to provide significant opportunities for abuse.

## 7. Getting the accounting for tax right - the IASB agenda

'Secrecy spaces' are required if corruption is to take place. Tax havens provide one such space. Subsidiaries inside groups of companies are another.

The previous recommendation has dealt with these in disclosure to tax authorities. Public disclosure is also essential if their capacity to do harm is to be curtailed.

No one knows whether the inventors of limited liability corporations intended that limited liability should be available within groups of companies, as well as when considering a group's third party relationships but as a matter of fact limitation of liability does apply within groups. This has the following consequences:

1. Multinational groups tend to be made up of hundreds, often thousands, of companies<sup>227</sup>;
2. Most countries tax each company in a group individually, and not the group itself;
3. Many of the companies in most groups are registered in territories that do not require accounts to be made available for public inspection;
4. Group consolidated accounts only record the third party transactions of a group of companies, but it is estimated that 60 per cent of world trade is now undertaken on an intra-group basis<sup>228</sup>. The outcome is that these accounts provide no meaningful representation of much that happens in the world of commerce, or across international boundaries;
5. Group consolidated accounts do not usually require a company to disclose:
  - a. Where it trades;
  - b. The names of all the entities through which it trades.

<sup>227</sup> BP Group is estimated to contain about 3,000 companies at present based upon its most recent data filed with the Registrar of Companies in the UK.

<sup>228</sup> See [http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer\\_p](http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer_p)

The resulting 'secret spaces' have been little explored<sup>229</sup> but tax administrators around the world know the problems that this situation creates in terms of establishing group structures, internal supply chains, cross charging mechanisms and all the related issues that flow from these, with consequent opportunity for capital flight and tax abuse.

Campaigners for transparency in the extractive sector have been particularly aware of this issue. The work of the Publish What You Pay coalition<sup>230</sup> (PWYP) prompted the Extractive Industries Transparency Initiative<sup>231</sup> (EITI). This has developed significant awareness of the need for any government to account for the funds paid to it. But it quickly became apparent that all the EITI was doing was to account for what companies declared they owed. There was no way of knowing whether the sum paid had any relation to the sum actually due. The truth and fairness of the payment is not assessed by the EITI reconciliation process. As campaigners came to realise, knowing that 95 per cent of the revenues companies have declared are accounted for by governments is of relatively little value if the declared payments are only half the real sum due.

The TJN has worked with PWYP to tackle this issue. The first result was a proposal for an international accounting standard<sup>232</sup> for the extractive industries. This was subsequently expanded to be a proposed

standard that tackled the issue for all companies subject to International Financial Reporting Standards whatever sector they work in<sup>233</sup>. This proposed standard, which has been widely circulated, calls for disclosure of the following information:

1. A list of the names of all the territories within which the group has subsidiary or associated companies, without exception;
2. The names of all subsidiaries and associates in each territory, without exception;
3. The following information on a consolidated country-by-country basis, without exception:
  - a. Turnover in total;
  - b. Third party turnover;
  - c. Third party costs excluding those of employment;
  - d. Interest, royalties and licence fees paid;
  - e. Profit before tax;
  - f. Tax charge on profits split between current and deferred tax;
  - g. Other taxes or equivalent charges due to the government of the territory in respect of local operations;
  - h. The actual payments made to the government of the country and its agencies for tax and equivalent charges in the period;
  - i. The liabilities owing locally for tax and equivalent charges at the beginning and end of each period as shown on the balance sheet at each such date;

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229 A paper on this subject is forthcoming from Ronen Palan and Richard Murphy, both of the Centre for Global Political Economy at the University of Sussex.

230 <http://www.publishwhatyoupay.org/>

231 <http://www.eitransparency.org/section/about/eiti>

232 <http://www.publishwhatyoupay.org/english/objectives/ias.shtml>

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233 <http://www.taxresearch.org.uk/documents/ias14final.pdf>

- j. Deferred taxation liabilities for the country at the start and close of the period;
- k. Gross and net assets employed;
- l. The number of employees engaged, their gross remuneration and related costs;
- m. Comparative data where appropriate in each case.

This is not complete profit and loss account information, but it should be sufficient to ensure that questions may be asked of any group that undertakes substantial intra-group transactions giving rise to risk for taxation authorities, or shareholders come to that (a point which we think has considerable significance in view of the extensive use of offshore and intra-group transactions to distort reported results in many of the recent corporate failures).

This proposal was put to the International Accounting Standards Board (IASB)<sup>234</sup> in 2006 and more than 50 per cent of all submissions on this and related topics to be discussed by that Board were supportive of the submission. This did not mean that it has been adopted as a standard at this time, but the IASB was persuaded that the arguments submitted had merit and said in November 2006 that:

*The Board will continue to examine the merits for a requirement of country-by-country disclosure as suggested by supporters of the Publish What You Pay campaign. A group of Board members will discuss this issue with other interested organisations.*<sup>235</sup>

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<sup>234</sup> <http://www.iasb.co.uk/>

<sup>235</sup> <http://www.iasb.org/News/Press+Releases/IASB+issues+convergence+standard+on+segment+reporting.htm>

It is our hope that all governments will back this submission in its broadest form, in which it applies to all entities subject to International Financial Reporting Standards. Put simply, there is no quicker win available in the entire arena at this time to expose data on who is trading where within groups of companies.

In our opinion this standard would radically transform international accounting practices, provide data previously unavailable to governments throughout the world on the activities of groups with operations located within their territories. Implementation of the proposed standard would provide incentive to improve corporate behaviour at the highest level in a way that nothing else could achieve.

## 8. Protecting professional advisers who do not wish to use offshore

There is a widespread belief amongst accountants, promoted in no small part by the biggest firms, that they have a duty to minimise the tax paid by their clients.

This duty has been reinforced by law on occasion, as has been noted in the chapter of this report relating to tax intermediaries.

There can be no sense in a government supporting law within its country that requires tax intermediaries operating there to provide advice to their clients on means available to subvert the income stream of that country, from which they probably hold a licence to operate.

In consequence it is essential that countries seek to protect those tax intermediaries who wish to practice tax compliance from legal claim arising from doing so. This might be by making it legally acceptable for any tax intermediary to make clear in their

contract for services to be supplied that they do not supply services in connection with:

- a. Tax avoidance (as defined in this report);
- b. Trusts, other than those used for the protection of children, the aged and the infirm or for charitable purposes and then only so long as the intention is not to secure tax advantage by doing so;
- c. The insertion of artificial steps into transactions for the sole purpose of securing a tax advantage;
- d. Offshore services of any sort.

In addition, it should be possible for them to require that their clients agree in advance to full disclosure of all relevant information required for proper appraisal of their taxation affairs by all relevant tax authorities on a consistent basis without risk of liability of inappropriate disclosure of information arising.

These recommendations would enable tax practitioners who would prefer to practice tax compliance, as many do, to reject the current pressure to recommend aggressive tax avoidance strategies.

## 9. Encouraging local professional bodies representing tax intermediaries to adopt Codes of Conduct which make clear that tax avoidance is unacceptable

The TJN has not been able to find a single provision in the ethical codes issued by professional bodies representing tax intermediaries which suggests tax avoidance is inappropriate conduct for a member of that body to undertake. Nor has it found any such codes which suggests that the members of that body

should be wary (at least) of the use of offshore structures, or of being involved in their supply or management.

This is unsurprising. As Professor Prem Sikka et al have noted<sup>236</sup>:

*In advancing the 'professionalising' claims, the UK accountancy bodies emphasise that their members have command of practical and theoretical education, engage in ethical conduct, serve the public interest and act in a socially responsible way.*

*However, such claims are routinely problematised by scandals which highlight the highly partisan role of accounting and accountants and failures of accounting education. Rather than a radical review of accounting education, the professional bodies seek to rebuild confidence in accounting and their jurisdictions by (re)affirming that accounting education is or will be devoted to producing reflective accountants through educational processes focused on sound education, principles, ethics, professional scepticism, lifelong learning opportunities, distinguishing between private and public interest and serving the public interest. These promises presuppose that students on professional accounting courses are exposed to such values. . . beyond a technical and instrumental view of accounting, there is little discussion of theories, principles, ethics, public interest, globalisation, scandals or social responsibility to produce socially reflective accountants.*

There is clearly a major weakness in the role of the professional bodies who work

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236 *Professionalising Claims And The State Of UK Professional Accountancy Education: Some Evidence* Sikka, P, Haslam, C, Agrizzi, D, Kyriacou, O 2005, *Accounting Education*, Vol. 16, No. 1 available at [http://www.essex.ac.uk/afm/research/workin\\_g\\_papers/WP05-05.pdf](http://www.essex.ac.uk/afm/research/workin_g_papers/WP05-05.pdf) accessed 28-1-07



in this area when addressing this issue. This has to be addressed through constructive debate between relevant authorities and those bodies, and between the members of those bodies themselves. There is also a significant issue needing to be considered by those who design and supply the curricula used in the training of these professions both at universities and for professional examinations.

The TJN and the Association for Accountancy and Business Affairs<sup>237</sup> will be publishing a proposed Code of Conduct for the management of taxation in the Spring of 2007.

## 10. Introducing general anti-avoidance provisions

One of the most consistent themes in discussion about taxation in the twenty first century has been the increasing volume and alleged complexity of tax legislation. There have been widespread calls for simplification of tax codes and for greater clarity as to their meaning.

Clarity is a desirable attribute of good tax legislation. It helps tax payers know what their obligations are. The greater the degree of legal clarity, the less chance there is for dispute as to its interpretation. Absolute clarity, let alone certainty, is not possible in taxation legislation for the following reasons:

1. The meaning of all words is, to varying degrees, ambiguous;
2. Taxation uses words in special ways, the interpretation of which is peculiar to its needs;
3. The meaning of words, both in general and in particular, changes over time so that the way in which legislation is

interpreted will also evolve since tax legislation cannot continually be amended and be effective.

In addition, the following issues impact on the clarity of legislation:

- Governments frequently wish to provide taxpayers with choice in the way in which they can construct legitimate economic transactions e.g. the benefit of using a piece of capital equipment can be secured by building it one's self, or by buying it, leasing it in the long term, hiring it in the short term or even by barter. All have an almost infinite number of variations possible within them. All require differing rules. The sheer complexity of the real world means that taxation legislation must either seek to restrict the way in which real economic transactions are undertaken or be as complex as the reality that people create. Enlightened governments have not chosen to restrict commerce, but the consequence is increased absolute volumes of legislation and, in consequence, further boundaries between the ways in which transactions can be treated. This gives rise for opportunity for misinterpretation that requires clarification within the legislation.
- Some accountants and lawyers have sought to abuse the boundaries of the law for their own advantage in generating fees and for the advantage of those they represent. This practice has given rise to an almost universal world-wide growth in the volume of tax legislation designed solely to tackle this issue. In the UK the TJN has estimated that at least 40 per cent of all UK tax legislation in the

<sup>237</sup> <http://visar.csustan.edu/aaba/home.htm>

period 2004 - 06 created anti-avoidance provisions<sup>238</sup>.

- It is accepted that this volume of anti-avoidance legislation has made it difficult to keep track of the purpose of some law, even for the experienced reader.

There are three ways to challenge this issue of complexity. The first, as noted above is to change the attitude of taxpayers, their advisers and governments towards the payment of tax. It is regularly cast by all as a "bad" thing. This is not true. Secondly, the claim by some tax professionals that they have a duty to minimise their client's tax liabilities has to be challenged.

Thirdly, and as importantly, governments have to embrace the idea of 'purposive legislation' in which they state the intent of the legislation they pass. To ensure that this is effective they must, however, couple that with a general anti-avoidance principle (GANTIP) that examines the intentions of the taxpayer as revealed both by the structure of the transactions they undertake, the outcomes they seek to achieve and any evidence available as to their motives before or after the transaction occurred to see if their intention coincides with the purpose of the legislation from which they have sought advantage. If it is clear from evidence procured in this way that the legislation was not intended to supply the benefit the taxpayer is seeking to procure from the transaction they are undertaking then the claimed benefit should be denied.

To ensure that the case load of litigation does not become burdensome as a consequence of such a system of taxation

legislation taxpayers would need to be able to apply for a ruling in advance of a transaction as to the likely treatment it would receive for taxation purposes, always assuming they did what they claimed was their intention.

## 11. Changing the basis of legal interpretation in tax cases so that an equitable and not legal basis of construction of the law is used

As has been discussed in this report, governments too often require that taxation law be applied by their Courts using a 'legal' rather than an 'equitable' basis of interpretation of the law. As those who first promoted this idea recognised, the outcome can be tax injustice. Application of this approach is, in addition, the foundation of the whole tax avoidance industry.

The use of an equitable basis of interpretation of the law would fundamentally change the way in which tax law was applied by the Courts of a country and would promote tax compliance rather than tax avoidance. As such this method of legal interpretation should be required of taxation courts.

## 12. Enhanced government accounting

The logic of the Publish What You Pay campaign has been that governments in developing countries rich in mineral and other natural resources should be held accountable for the funds paid to them by major corporations. The purpose has been twofold:

1. To ensure that corruption is exposed, as far as is possible;

238

<http://www.taxresearch.org.uk/Documents/TJNresearchnote12-06.pdf> accessed 15-12-06

2. To ensure that funds entrusted to a government are used to be best effect.

These objectives are as appropriate in developed countries and those without mineral resources as they are in those countries that Publish What You Pay target. In addition, it is apparent that a government cannot operate opaquely if it is requiring transparency of others.

As such governments should ensure that:

- They provide clear, easily accessed information on budgets as well as income received and the way in which it is expended, provided on a timely basis and in consistent and readily understood formats, in which outcomes are also compared with expectations;
- They relate this information in such fashion that an individual can comprehend how they relate to the income, expenditure and activities of government and this must be explicitly highlighted in the data published by governments;
- Their reporting recognises that well being matters as much as GDP;
- The distribution of income and the tax burden is recognised as an important issue and is highlighted in all reporting.

Only if these changes happen can governments realistically ask the same of corporations and other legally created entities.

**13. Publication of 'tax gap' measures at national level so that the scale of the problem is known**

**and targets can be set for dealing with it;**

Few countries publish measure of their 'tax gaps'. This is the estimated difference between the tax revenues they collect and what should be collected if there were no:

- Tax evasion;
- Aggressive tax avoidance;
- Non-payment of taxes due.

The USA is a notable exception. It both actively recognises the existence of its tax gap<sup>239</sup>, estimates what it is (between US\$312 billion and US\$353 billion in tax year 2001)<sup>240</sup> and asks what might be done about<sup>241</sup>. Even so, the US definition of the tax gap is itself deficient. It is:

*The difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law.*<sup>242</sup>

This does not take into account:

- Tax lost due to tax competition;
- Tax lost offshore.

As a result the loss is likely to be higher than that reported.

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239 See, for example [http://taxprof.typepad.com/taxprof\\_blog/2007/01/senate\\_holds\\_he\\_1.html](http://taxprof.typepad.com/taxprof_blog/2007/01/senate_holds_he_1.html) accessed 28-1-07

240 <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> accessed 28-1-07

241 See, for example, [http://budget.senate.gov/democratic/testimony/2007/Brstek\\_taxgap012307.pdf](http://budget.senate.gov/democratic/testimony/2007/Brstek_taxgap012307.pdf) accessed 28-1-07

242 *ibid*, page 1

The point remains though that without some estimate of the problem there is neither a target to address (although closing the tax gap altogether is, we stress a known impossibility – tax evasion will always exist) or a means of holding anyone to account for progress.

As the United States Government Accountability Office also says in its report to the Senate in January 2007:

*Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major approaches, but providing quality services to taxpayers also is a necessary foundation for voluntary compliance. Such steps as periodically measuring non-compliance and its causes, setting tax gap reduction goals, evaluating the results of any initiatives to reduce the tax gap, optimizing the allocation of IRS's resources, and leveraging technology to enhance IRS's efficiency would also contribute to tax gap reduction.*

We would endorse those sentiments and believe that research into and the promotion of accountability for the 'tax gap' is an essential part of every governments taxation system if this issue is to be tackled effectively and the funds needed for development are to be raised to achieve the Millennium Development Goals.

**14. Redefining what 'residence' means for both individuals and other entities to make it easier to define trusts and corporations held through nominee arrangements as being managed from the territories in which effective control takes place**

As has been noted in the chapter on offshore, many (possibly a majority) of

the structures nominally located offshore are actually under the effective day to day management of companies, and individuals in other countries. As the US Senate report into offshore published 1 August 2006 noted:

*Offshore "service providers" in tax havens use trustees, directors, and officers who comply with client directions when managing offshore trusts or shell corporations established by those clients; the offshore trusts and shell corporations do not act independently.*

As a result the Senate report recommended that:

*U.S. tax, securities, and anti-money laundering laws should include a presumption that offshore trusts and shell corporations are under the control of the U.S. persons supplying or directing the use of the offshore assets, where those trusts or shell corporations are located in a jurisdiction designated as a tax haven by the U.S. Treasury Secretary.*

The authors of this report endorse this recommendation. If it were adopted, those offshore trusts and companies would be subject to tax in the country from which the direction was issued.

We have two further proposals:

- a. It should be for the taxpayer to prove that such control does not exist;
- b. The existence of a commercial activity within the trust or offshore company should not be a reason for exclusion from this provision (as it is at present under the 'controlled foreign company' tax laws of many countries<sup>243</sup>).

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243 For a description of the UK's definition of a controlled foreign company see <http://www.hmrc.gov.uk/manuals/intmanual/intm202010.htm> accessed 28-1-07

- c. Controlled foreign company laws should be extended to individuals so that they can be charged to tax on the income of companies, trusts and other entities that they control located offshore where this is currently not possible.

These would add additional opportunity to address this problem.

### **15. Create an obligation for financial institutions to disclose ownership of foreign registered entities for whom they act.**

US Senators Coleman and Levin recommended as follows in their August 2006 Senate report:

*Congress and the IRS should make it clear that a U.S. financial institution that opens an account for a foreign trust or shell corporation and determines, as part of its anti-money laundering duties, that the beneficial owner of the account is a U.S. taxpayer, must file a 1099 form with respect to that beneficial owner.*

This recommendation is quite clearly intended to take disclosure on beneficial ownership beyond that suggested here in recommendation 3 above for domestically registered corporations. The intention is obvious: knowing who owns domestic corporations is useful, knowing the ownership of those operating offshore with links to your own country is even more important.

The recommendation could be adopted by other countries. Extension should also be considered:

- a. As a condition of a banking licence to operate in a country this requirement could be placed on the group of

countries of which it is a member to ensure that this disclosure is made wherever the account is opened;

- b. The Requirement could be extended to the providers of credit card services. Mastercard is a US quoted corporation. Visa is owned by the banks who supply its cards<sup>244</sup>. Both are used for money laundering and tax fraud, although neither does of course engage in such activity itself, or in any way encourage it. However the possibility that restrictions on the international use of such cards for what are deemed to be criminal payments domestically has been proven to be possible in the USA where the Unlawful Internet Gambling Enforcement Act, passed in November 2006<sup>245</sup> made use of such cards to pay for on-line gambling an offence, even where the payment was to an offshore provider. The possibility of extending this restriction to limit the use of cards registered in tax havens has to be considered as a serious possibility, and the providers should be asked to actively engage in this debate.

### **16. Sanctions should be applied to tax havens unwilling to cooperate with domestic governments seeking to recover tax legitimately due to them.**

Lack of willingness to cooperate in this case might include:

<sup>244</sup> According to *Business Week* in 2005 'MasterCard processed US\$1.03 trillion in transactions last year, less than half of Visa's US\$2.27 trillion. AmEx is a distant third, at US\$414 billion.'  
[http://www.businessweek.com/magazine/content/05\\_49/b3962112.htm](http://www.businessweek.com/magazine/content/05_49/b3962112.htm) accessed 28-1-07

<sup>245</sup> See <http://www.msnbc.msn.com/id/15118962/> for some discussion of this Act, accessed 28-1-07

- A lack of willingness to engage in automatic information exchange;
- Failure to exchange data on a timely basis;
- Failure to hold the data needed to ensure effective information exchange can take place (including the names of beneficial owners, copies of accounts and tax returns, details of distributions including dividends, salaries, loans, the provision of benefits in kind or plain straight forward cash advances made to persons in the country of enquiry);
- A willingness to impose appropriate regulation on offshore entities registered in their territory.

Senators Coleman and Levin suggested the following in these cases:

*Congress should authorize the Treasury Secretary to identify tax havens that do not cooperate with U.S. tax enforcement efforts and eliminate U.S. tax benefits for income attributed to those jurisdictions.*<sup>246</sup>

To this Bob McIntyre of Citizens for Tax Justice has added the following:

*Not only deny all deductions for transfers to tax havens that refuse to disclose activity by U.S. residents automatically, but also make it illegal for U.S. financial companies to deal with uncooperating tax havens. Some argue that we would need to get every other non-tax-haven real country on board with this type of proposal, or otherwise people will route their transactions through real countries into the tax havens. But as noted, other countries are likely to be eager to join us in this effort. In fact, the OECD's new model treaty envisions this result.*

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246 Quoted in <http://www.ctj.org/pdf/mcintyretaxgaptestimony.pdf> page 4 accessed 28-1-07

There is evidence to support this last suggestion. In that case this form of action is now possible unilaterally with the expectation of cumulative benefit.

One of the sanctions that might be imposed on territories not willing to cooperate could be the application of tax withholding on territories made to that country or territory. Whilst attempts would be made to circumvent such sanctions it is a simple fact that if tax withholding at source were to be applied to the payment of interest from the London money markets to the banks that holds billions in deposits in the Channel Islands, the Isle of Man and Cayman much of the attraction of these locations would disappear overnight.

## **17. Apply tougher sanctions on those not willing to comply with taxation law**

The range of sanctions available here are considerable, and too often they have been used inappropriately. There are frequent claims in major tax administrations that sanctions are applied to the less well off who have made minor errors in computing their tax liabilities whilst those who simply evade taxes, either domestically or through the use of offshore are ignored. In addition large companies who secure legal opinion (often at considerable expense) to justify their aggressive tax avoidance cannot be penalised in many tax jurisdictions. Finally, it is often difficult to penalise tax intermediaries for their part in unacceptable tax planning. Each of these has to be addressed. Suggestions for change might be:

- A shift in the emphasis of tax audits away from those who are seeking to comply with the law, but who might make minor technical errors whilst



doing so towards a focus on aggressive tax avoidance and outright tax evasion;

- The reduction of penalty risks for those who are tax compliant, including those advisers who encourage this practice, and a focus on higher penalties for those who seek to break the law;
- The assumption that funds that have been secured using tax evasion mechanisms have been money laundered and as such should be forfeited as the proceeds of crime. If it is not possible to prove which part of a sum has arisen as a result of tax evasion and what part has not (e.g. where an account might include a capital sum placed offshore to which interest on which tax has been evaded has been added) then the entire sum should be frozen until the taxpayer can prove what, if any, part might have been legitimately secured in a transaction which had been subject to taxation as required by law.
- Failed tax avoidance schemes should be assumed to have constituted tax evasion and be subject to sanction as such. Prior clearance mechanisms for proposed transactions as recommended in this report make this equitable;
- The removal of the defence of having secured legal opinion to justify aggressive tax avoidance when it is clear that the transaction in question is not tax compliant and would breach the requirements of a general anti-avoidance provision, with penalties being due in such cases as a result;
- Making it a requirement that all tax agents operating within a state and wishing to sell services into a state be registered before being allowed to provide taxation advice. This is the case, for example in the USA and Australia but is not required in the

UK. If such registration were required it should be a condition that:

- The registration should apply to all parts of the registered firm. As such, if the registered firm had associated firms, members of its group or related activities in other countries, including in tax havens then registration would require that the firms in other countries would be bound to comply and provide information required by the tax authorities in the country in which registration had taken place as if they too were located there. The legal fiction that multinational firms of accountants who share names, market their services on a unified basis and even share common management structures are entirely unrelated entities (as is still commonplace amongst, and for example, the Big 4 firms of accountants) has to be ended once and for all. In a global world international professional firms have to be accountable. The withdrawal of a firms licence to operate and the imposition of sanctions, including criminal sanctions akin to those for assisting money laundering should be used in the case of non-compliance in these cases, including for failure to disclose such relationships if they exist.
- The disclosure of tax planning should be mandatory;
- The participation of a firm in assisting submission of a tax return which did not make disclosure of all relevant material information required

to ensure that a tax liability was appropriately determined would be liable to sanction as well as withdrawal of the firms licence as well as that of those personally responsible so that they cannot then transfer to another firm and carry on as before (which in most cases will be the most significant sanction of all);

- The failure to disclose tax transactions consistently to different tax authorities should also be subject to sanction on the part of the firm involved.

## 18. Increase the resources available to taxation departments to ensure that the measures recommended in this report can be implemented.

In the USA it has been reported that:

*According to the National Taxpayer's Advocate, "On a budget of about US\$10.6 billion, the IRS currently collects about US\$2.24 trillion a year. That translates to an average return-on-investment (ROI) of about 210:1. . . . [F]ormer Commissioner Rossotti reported the IRS was receiving sufficient resources to work only 40 percent of some 4.5 million accounts receivable cases each year. IRS research estimated that with an additional US\$296.4 million, the agency could collect US\$9.47 billion. That translates to a return on investment of 32:1."*<sup>247</sup>

Despite this obvious, and attractive rate of return many governments, including those of the UK and USA are reducing the

cash they are willing to commit to tax collection. The logic of this approach is hard to fathom. As Bob McIntyre of Citizens for Tax justice has argued before a Senate committee:

*With additional funding, the IRS could devote more resources to international tax evasion, partnership document matching, capital gains under-reporting, serious research and an array of other critical enforcement activities. According to IRS estimates, it could collect from US\$5 to more than US\$30 for every dollar spent on improved enforcement.*

*If enforcement changes deter people and companies from even attempting abusive tax sheltering activities, then the rate of return could be even higher.*<sup>248</sup>

The logic appears irrefutable. We endorse the suggestion.

## International changes

Perhaps surprisingly, but altogether consistently with the theme of this report, the range of issues that need to be tackled internationally is shorter than that needing domestic attention. They include:

### 1. Working to change the international definition of corruption.

This is an extension of the same theme at a domestic level. It would require engagement with the United Nations, World Bank, IMF, Transparency International, and other agencies to achieve this objective;

247 National Taxpayer Advocate's 2006 Annual Report to Congress, Dec. 31, 2006, pp. 442 & 444 quoted at page 7 <http://www.ctj.org/pdf/mcintyretaxgaptestimony.pdf> accessed 28-1-07

248 *ibid*

## 2. Asking the IMF to enhance its Reviews of Standards and Codes (ROSCs).

These reviews are considered of significance by all covered by them<sup>249</sup>. They do not, however, cover all the areas where action is needed and the review should be subject to additional testing to determine:

- a. Which countries are willing to over-rule banking secrecy in cases of suspected tax fraud;
- b. Which countries and territories actually hold the data required to answer enquiries from other states on:
  - i. Beneficial ownership;
  - ii. Income received;
  - iii. Tax paid;
  - iv. Remittances made;
- c. Which countries do in practice exchange such information;
- d. How long they take to do so.

This data could then be used in association with that noted in the next section.

## 3. To use the data assessments undertaken by the OECD included in 'Towards a Level Playing Field' published as the '2006 Assessment by the Global Forum on Taxation' to create a new 'black list' of uncooperative states with regard to international taxation.

This objective basis for determining which states are and are not in practice

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<sup>249</sup> See <http://www.imf.org/external/np/rosc/rosc.asp> for more information on these procedures.

uncooperative with regard to taxation matters would be based upon an objective matrix determined by the territory in question's:

- secrecy provisions concerning corporate law;
- secrecy requirements regarding trust law;
- banking secrecy arrangements, and the willingness of the state to override them when required;
- the availability of information to exchange;
- the willingness to exchange information;
- the speed with which information exchange takes place;
- the speed with which assistance is provided to ensure the effective recovery and repatriation of assets illegally transferred from jurisdiction to jurisdiction as required by model taxation treaties;
- willingness to promote enhanced standards for international tax collection and international tax enforcement.

Once confirmed these rankings would then be used to determine what appropriate counter-measures were required with regard to states which refuse to cooperate in international taxation matters. Possible courses of action need to be researched (see section 4 of these recommendations).

## The provision of direct assistance to developing countries

The focus of this report is on closing the floodgates which are presently allowing the loss of considerable sums of taxation due. These losses are, inevitably, higher

in the developed world than the developing world as income and taxation levels are higher in the developed world. However, the reason for taking this action is argued to be that the additional revenues earned can be used to achieve the Millennium Development Goals and to assist the developing countries of the world to break free from aid dependency, which in turn reduces the political accountability of their own governments.

For achieve this shift to self-dependence on the part of developing countries, direct assistance is required for:

1. The training of tax officials in developing countries including the payment of salaries sufficient to make corruption or commercial sector poaching unlikely;
2. The provision of appropriate IT systems to developing country tax authorities;
3. The promotion of locally appropriate accounting systems to enhance tax declaration. These may be quite different from those used in developed countries;
4. The design of taxes suited to local circumstances. This might require abandonment of the current IMF conditionality that has required the abandonment of tariffs and the promotion of the idea that VAT and other indirect taxes are the solution to all taxation problems when it is apparent from experience on the ground that this is not the case.
5. Support for identifying financial crime;
6. Assistance for initiatives such as the Extractive Industries Transparency Initiative<sup>250</sup>, and their expansion to all material sectors of the economy;

7. Technical help in developing taxation measures to mitigate the effects of tax avoidance and evasion;
8. Practical assistance in the supply of information where mispricing is believed to have taken place at cost to the country in question;
9. The supply of similar information, without request where it is believed that capital flight is taking place;
10. The development of automatic information exchange regimes between developed and developing countries.

This list is indicative of what is possible. The governments of developing countries are as much free agents as any other, and this report recognises it is for them to assess their needs, determine their strategy and to ask for assistance if they see fit. For too long one of the problems they have faced has been that tax solutions have been imposed upon them. This has to change. It is, however, appropriate to note that the transfer of appropriate expertise, technology, information and support to the taxation authorities of these countries is bound to be of benefit to them in developing strong and predictable income streams based on taxation.

There is one further way in which developed countries can assist in this process. When negotiating double tax treaties with developing nations they might offer to use the UN model tax treaty rather than the OECD model tax treaty as a basis on which to work. The UN model tends to favour developing countries as it has a bias to source based taxation inherent within it.

### To promote research

If this report has proved anything it is that in many vital areas insufficient is known about the scale of the problems of capital

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<sup>250</sup> See <http://www.eitransparency.org/section/about/eiti> accessed 28-1-07

flight and tax evasion. For example too little is known about:

14. Funds held offshore;
15. Capital flight flows;
16. The actual target destination of foreign direct investment;
17. What is happening in the tax havens (although research over recent years has helped);
18. The extent to which information sharing is taking place;
19. The cost that offshore and other tax planning activities impose on governments;
20. The size of the tax gap around the world;
21. The structure of the world's major corporations and the degree to which their decisions are tax driven;
22. The economic impact of trade mispricing;
23. The role of tax competition in development and the potential costs that have arisen from it;
24. The real role of the tax intermediaries and their professional bodies in promoting tax avoidance, and what can be done about it;
25. The impact of the tax losses arising from offshore and other tax planning both on income distribution per head and also on distribution by gender and between ethnic and race groups;
26. The impact of tax planning on trade and the loss of welfare that might result from the distortions that tax planning and tax driven corporate structures add into the trade mechanisms of the world.

This list is, like that in the previous section, indicative. The authors strongly

endorse any effort that can be taken to research these issues more fully.

In addition this report has provided the most comprehensive list of recommendations on how this problem can be tackled ever published. These recommendations require fuller appraisal to test their operational practicability:

11. Mechanisms on promoting automatic information exchange for individuals, trusts and bodies created by statute law;
12. What an appropriate Code of Conduct for the professions might look like;
13. Practical mechanisms to prevent trade mispricing, including those referred to by Simon Pak in his chapter
14. Alternatives to the current 'arm's length principle' basis for international corporate taxation which is now outmoded;
15. Methods of accounting for governments which might communicate key information to taxpayers to induce greater tax compliance;
16. Appropriate accounting systems for use in developing and other countries that might assist tax compliance;
17. Ways in which tax codes might be simplified whilst broadening the taxation base;
18. Means of successfully introducing general anti-avoidance principles into taxation law;
19. The possibility of creating a world tax authority and what powers it might need to regulate this sector;
20. Ways in which taxes might be charged on MNCs on a global basis.

This is an ambitious programme. However, action in this area has the greatest

possibility of raising the funds needed to pay for the Millennium Development Goals, to fund stable developing countries and to provide the security needed as governments move on to face the growing problem of global warming. This agenda might be bold, but the problems identified are huge in scope and bold measures are called for. The failure on the part of the international community,

and in particular the IMF and World Bank, to tackle the fiscal termites in the global financial architecture has nurtured a tax environment in which crime pays. Determined measures are needed to roll back this criminogenic environment and re-establish public respect for the integrity and equity of national tax systems.



# Chapter 10

## Tackling harmful tax practices

David E. Spencer JD LLM, Attorney

The seminal 1998 report “Harmful Tax Practices: An Emerging Global Issue” of the Organization for Economic Cooperation and Development (“OECD”) played a pioneering role in focusing attention on tax avoidance/tax evasion in the international context. That 1998 OECD Report resulted in the OECD’s Proposals on Harmful Tax Practices, primarily transparency and exchange of information requirements. These OECD Proposals have been analyzed and debated within the structure of the OECD, primarily in the OECD’s Forum on Harmful Tax Practices.

However, the OECD’s Proposals on Harmful Tax Practices have not been implemented:

- The OECD’s Proposals would impose on jurisdictions designated by the OECD as tax havens, obligations of transparency and exchange of information that some OECD member countries, in particular the OECD financial centres, were not willing to accept for themselves. The tax havens rebelled, using a “level playing field” argument. The OECD capitulated, and has in effect converted the OECD Proposals into a voluntary program which each OECD designated tax haven may or may not implement.
- The OECD’s Proposals did not confront or even admit a major problem in the international financial architecture: Capital flight from third countries into OECD designated

tax havens and into OECD member countries, and in particular the OECD financial centres.

- Although the OECD has repeatedly emphasized “*effective* exchange of information”, the OECD Proposals would only require exchange of information upon request. However exchange of information upon request does not constitute effective exchange of information. Automatic exchange of information would be more effective, but there are technical problems in implementing automatic exchange of information. The OECD has made significant efforts in trying to resolve the technical problems in automatic exchange of information.

In view of the failure of the OECD Proposals, the forum, the message and the players have to change.

### 1. The United Nations

Since the Monterrey Consensus of 2002, the United Nations has called upon developing countries to mobilize domestic resources for development. The World Summit Outcome of September 2005 adopted by the General Assembly of the United Nations also emphasized that developing countries have to mobilize domestic resources for development. But the massive capital flight from third countries into OECD financial centres and into other tax havens financial centres,

and the resulting tax evasion and loss of tax revenue in developing countries severely undercuts the ability of developing countries to mobilize domestic resources. Indeed the 2005 World Summit Outcome confirmed that “We therefore resolve... to support efforts to reduce capital flight and measures to curb the illicit transfer of funds.”

Developing countries and countries which are not financial centres have been remarkably passive in the United Nations about the capital flight issue. The Group of 77 and China should emphasize this issue at the United Nations, and adopt a more dynamic and forceful position at the United Nations, whether it be in the General Assembly, ECOSOC or in the UN Committee of Experts on International Cooperation in Tax Matters.

## 2. Tax Evasion/Tax Avoidance and Capital Flight as Corruption

The TJN has noted that civil society groups like Transparency International have focused on corruption in developing countries, without considering that financial institutions and governments in the OECD financial centres and other tax haven financial centres are key facilitators and participants in capital flight and tax evasion/tax avoidance which clearly constitute forms of corruption. Examples include:

- Corruption by financial intermediaries that knowingly encourage and facilitate capital flight and the resulting tax evasion.
- Public sector corruption by the governments in the onshore and offshore financial centres that provide bank secrecy and other confidential treatment in tax matters, which facilitates and encourages capital flight from other countries and tax evasion in those

other countries. Thus, governments in onshore and offshore financial centres knowingly aid and abet corruption.

The International Financial Institutions (World Bank, IMF, African Development Bank, Asian Development Bank, Inter-American Development Bank, European Investment Bank, and European Bank for Reconstruction and Development) are preparing a uniform framework for preventing fraud and corruption. That uniform framework should include capital flight and the resulting tax evasion within the definition of corruption.

Civil society has to focus on this issue, and publicize this issue. Also, governments of developing countries and of countries which are not financial centres have to bring this aspect of corruption within the scope of the United Nations Convention Against Corruption.

## 3. The GT-7

The problem of capital flight to OECD financial centres and other tax haven financial centres, and the resulting tax evasion was discussed in the two papers that form the basis of the GT-7 program. These were the Landau Report<sup>251</sup> commissioned by President Jacques Chirac and the Lula Report<sup>252</sup>, Action against Hunger and Poverty.

Although the GT-7 has focused on “solidarity type taxes”, the volume of tax evasion resulting from capital flight is

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[http://www.conservaionfinance.org/Documents/CF\\_related\\_papers/Landau\\_commission\\_article2.pdf](http://www.conservaionfinance.org/Documents/CF_related_papers/Landau_commission_article2.pdf) accessed 26-1-07

252  
[http://www.cttcampaigns.info/documents/brasil/Report-final\\_per\\_cent20version.pdf](http://www.cttcampaigns.info/documents/brasil/Report-final_per_cent20version.pdf) accessed 26-1-07



much more serious: The TJN has estimated that the lost tax revenue annually from capital flight is about US\$255 billion on a world wide basis.

While continuing their laudable efforts to implement solidarity type taxes, the GT-7 countries should focus on the much more serious problems: the loss of tax revenue due to capital flight and the resulting tax evasion.

# Chapter 11

## Capital Flight and Tax Avoidance through Abnormal Pricing in International Trade - the issue and the solution

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In June 2005, the U.S. imported 32,000 GM of scrap gold from Mexico and paid US\$825,000. What is interesting about this import is that the unit value of the scrap gold US\$25.78/GM (equivalent to US\$801.85/oz) is substantially higher than the price of pure gold at the time, about US\$14.16/GM (equivalent to US\$440.85/oz.) The U.S. importer clearly overpaid for the scrap gold, sending capital to Mexico and reducing taxable income.

In August 2005, the U.S. imported 46 million GM of gold doré<sup>253</sup> from Peru at US\$1.79/GM (equivalent to US\$55.54/oz), paying a total of US\$82 million. The median price for gold doré is US\$12.47/GM based on an analysis of the 2005 U.S. import data. The Peruvian exporter sold gold doré at an abnormally low price, sending capital to the U.S. in the form of valuable commodity equivalent to about US\$574 million in value for a mere US\$82 million payment and reducing taxable income.

The two examples above are not particularly unusual. A detailed statistical

analysis of the U.S. merchandise import and export data published by the U.S. Government reveals abnormally low priced U.S. imports and abnormally high priced exports are quite common

For example, total exports from the Czech Republic to the U.S. were reported to be US\$2.21 billion in 2005. This sum did however represent an estimated underreported amount through abnormally low prices of US\$1.25 billion when calculated as deviations from lower quartile prices. Congo's 2005 total export to the U.S. were reported to be US\$262 million with an estimated underreported amount of about US\$35 million. In fact, the total underreported amount in all of the U.S. imports from all countries was estimated at approximately US\$202 billion in 2005 through abnormally low priced imports. [See table 1]

In 2005, the Philippines imported a total of US\$6.9 billion worth of merchandise from the U.S. The estimated over-reported value of the Philippines' imports from the U.S. was US\$1.1 billion through abnormally high priced imports from the U.S. when measured as deviations from upper quartile prices. Similarly, Malaysia's 2005 imports from the U.S. included

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253 Gold doré (pronounced gold doh-rey) is a bar of semi-purified gold (e.g. bullion)

approximately US\$1.4 billion as an estimated over-reported amount. In fact, the total over-reported amount in all of the U.S. exports to all countries was estimated as approximately US\$50 billion in 2005 through abnormally high priced exports. [See table 2]

The underreported amount of US\$202 billion in the 2005 U.S. merchandise imports and the over-reported amount of US\$50 billion in the 2005 U.S. merchandise exports represent 12.1 per cent of total U.S. imports and 5.5 per cent of total U.S. exports respectively.

Abnormally priced imports and exports may be due to recording or clerical errors in customs documents, heterogeneity of products within a give harmonized commodity code classification, or false invoicing. Physical inspection and/or investigation by the customs authority are necessary to determine the exact explanation for each abnormally priced trade.

False invoicing facilitates capital movement, money laundering, and duty or income tax avoidance. Abnormally high priced import transactions may be used to avoid income taxes by reporting high cost of goods sold resulting in a smaller amount of taxable profits reported. They may facilitate capital flight and money laundering through remittances disguised as seemingly legitimate payments for merchandise imported which has substantially lower value than being reported. They may also conceal illegal commissions that are hidden in the inflated prices.<sup>254</sup>

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254 De Boyrie, M., Pak, S.J., and Zdanowicz, J.S. *Money Laundering and Income Tax Evasion: The Determination of Optimal Audits and Inspections to Detect Abnormal Prices in International Trade* Journal of Financial Crime, Vol. 12, No. 2, 2004.

Abnormally low priced import transactions may reflect attempts to avoid or reduce import duties or the dumping of foreign produced goods at below market prices as a means of driving out domestic competition.<sup>255</sup>

Similarly, abnormally low priced export transactions may be utilized to avoid income taxes by reporting lower revenue resulting in a smaller amount of taxable profits reported. They may facilitate capital flight and money laundering by shipping valuable merchandise at prices substantially lower than true market value. This has the effect of sending valuable merchandise instead of money through seemingly legitimate export transactions. Abnormally high priced exports may also be used to exploit export subsidies available from several developing countries with export incentives.

Abnormally priced import and export transactions can be detected easily using a statistical approach, such as "price filter matrix." A price filter matrix can be constructed by calculating median price, upper quartile price, and lower quartile price for each harmonized commodity code by country using the most detailed import and export database collected and maintained by a customs agency of a country. Mean and standard deviation of prices may be calculated instead of median and upper/lower quartile prices.

The price filter matrix constructed may then be used to set an upper bound and a lower bound of prices to determine each import and export transactions as abnormally high or abnormally low.

The price filter matrix can be built for each commodity code and trading country combination, may be effective in identifying abnormally priced import and

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255 Ibid

export transactions, can be used for real-time inspection of cargo, and can also be used to estimate the amount of over- and under- pricing in export/import transactions. The steps described above can be automated through the use of computerized processes. Once an import or export transaction is flagged as abnormally priced, the customs agency will need to inspect physically and investigate the flagged transaction in detail to determine if the price of the flagged transaction is due to false invoicing or not. This approach will facilitate efficient customs clearance and fast movement of merchandise cargo at the ports.

A price filter matrix is calculated and used in estimating the amounts of capital movement and income shifting for 2005 U.S. imports and exports in tables 1 and 2. The dollar amounts are computed by aggregating the amount deviated from lower quartile price for every abnormally low priced U.S. import and the amount deviated from upper quartile price for every abnormally high priced U.S. export.

Countries adopting the statistical approach using a price filter matrix will be able to control and determine, by adjusting the upper and lower price bounds, both the level of physical inspection and the means of inspection that will result in the cost effective monitoring of their international trade flows.

When a country plans to implement the statistical approach in monitoring the transaction prices of international trade in an effort to minimize capital flight, duty and income tax avoidance, and money laundering, the following steps may be considered:

i) Generate and update the relevant statistical price filter matrix regularly;

ii) Employ a network of workstations and servers at the country's ports to facilitate the computerized analysis of international trade prices in real time;

iii) Use a printed price filter matrix if the country does not currently have computerized trade data entry system and need to implement the system manually;

iv) Decide who will conduct the audit of trade documents and the physical inspection of cargo with suspected transactions prices. This can be done by a private inspection firm or its customs agency.



**Table 2: 2005 Top 25 Sources of Capital & Income Shift to the U.S. through Abnormally Low Priced Import Transactions**

2005 Total Import	Import (billion)	Amount Shifted	
		Amount (billion)	Ratio to Import Amount
All Countries	\$1,670.9	\$202.1	12.1 per cent
Canada	\$287.9	\$15.6	5.4 per cent
China	\$243.5	\$18.5	7.6 per cent
Mexico	\$170.2	\$10.2	6.0 per cent
Japan	\$138.1	\$31.5	22.8 per cent
Federal Republic of Germany	\$84.8	\$25.6	30.2 per cent
United Kingdom	\$51.1	\$9.5	18.6 per cent
Korea, South	\$43.8	\$6.0	13.6 per cent
Taiwan	\$34.8	\$3.8	10.9 per cent
Venezuela	\$34.0	\$0.9	2.7 per cent
France	\$33.8	\$9.5	28.0 per cent
Malaysia	\$33.7	\$1.8	5.4 per cent
Italy	\$31.0	\$6.8	22.0 per cent
Ireland	\$28.6	\$3.0	10.6 per cent
Saudi Arabia	\$27.2	\$0.8	2.9 per cent
Brazil	\$24.4	\$1.3	5.4 per cent
Nigeria	\$24.2	\$0.6	2.3 per cent
Thailand	\$19.9	\$1.3	6.3 per cent
India	\$18.8	\$1.9	10.3 per cent
Israel	\$16.9	\$1.1	6.8 per cent
Russia	\$15.3	\$0.3	2.3 per cent
Singapore	\$15.1	\$11.5	76.2 per cent
Netherlands	\$14.9	\$10.9	73.2 per cent
Sweden	\$13.8	\$2.7	19.6 per cent
Belgium	\$13.0	\$3.0	22.8 per cent
Switzerland	\$13.0	\$3.9	30.0 per cent

**Table 2: 2005 Top 25 Sources of Capital & Income Shift to the U.S. through Abnormally High Priced Export Transactions**

2005 Total Export	Export (billion)	Amount Shifted	
		Amount (billion)	Ratio to Export Amount
All Countries	\$904.4	\$49.7	5.5 per cent
Canada	\$211.4	\$7.3	3.5 per cent
Mexico	\$120.0	\$5.6	4.6 per cent
Japan	\$55.4	\$3.4	6.2 per cent
China	\$41.8	\$2.6	6.1 per cent
United Kingdom	\$38.6	\$3.3	8.5 per cent
Federal Republic of Germany	\$34.1	\$2.4	6.9 per cent
Korea, South	\$27.7	\$1.6	5.7 per cent
Netherlands	\$26.5	\$1.8	6.8 per cent
France	\$22.4	\$1.5	6.6 per cent
Taiwan	\$22.0	\$2.0	9.2 per cent
Singapore	\$20.6	\$1.3	6.5 per cent
Belgium	\$18.6	\$1.3	6.8 per cent
Hong Kong	\$16.3	\$1.3	8.1 per cent
Australia	\$15.8	\$1.0	6.1 per cent
Brazil	\$15.3	\$1.0	6.3 per cent
Italy	\$11.5	\$0.7	6.0 per cent
Switzerland	\$10.7	\$0.4	4.0 per cent
Malaysia	\$10.5	\$1.4	13.8 per cent
Israel	\$9.7	\$0.5	5.6 per cent
Ireland	\$9.3	\$0.5	5.7 per cent
United Arab Emirates	\$8.5	\$0.4	4.4 per cent
India	\$8.0	\$0.5	6.2 per cent
Thailand	\$7.2	\$0.4	6.0 per cent
Spain	\$6.9	\$0.4	5.6 per cent
Philippines	\$6.9	\$1.1	16.5 per cent

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# Appendix 1

## Millennium Development Goals

The Millennium Development Goals are a statement of hope, and of vision, coupled to the practical objective of realising them:

*“We have the opportunity in the coming decade to cut world poverty by half. Billions more people could enjoy the fruits of the global economy. Tens of millions of lives can be saved. The practical solutions exist. The political framework is established. And for the first time,*

*the cost is utterly affordable. Whatever one’s motivation for attacking the crisis of extreme poverty—human rights, religious values, security, fiscal prudence, ideology—the solutions are the same. All that is needed is action.”*

(From Investing in Development, the Millennium Project Report)

The Goals are:

**The UN Millennium Development Goals**

**Goal 1: Eradicate extreme poverty and hunger**

- Reduce by half the proportion of people living on less than a dollar a day
- Reduce by half the proportion of people who suffer from hunger

**Goal 2: Achieve universal primary education**

- Ensure that all boys and girls complete a full course of primary education

**Goal 3: Promote gender equality and empower women**

- Eliminate gender disparity in primary and secondary education preferably by 2005, and at all levels by 2015

**Goal 4: Reduce Child mortality**

- Reduce by two thirds the mortality rate among children under five

**Goal 5: Improve maternal health**

- Reduce by three quarters the maternal mortality ratio

**Goal 6: Combat HIV/AIDS, malaria and other diseases**

- Halt and begin to reverse the spread of HIV/AIDS
- Halt and begin to reverse the incidence of malaria and other major diseases

**Goal 7: Ensure environmental sustainability**

- Integrate the principles of sustainable development into country policies and programmes; reverse loss of environmental resources
- Reduce by half the proportion of people without sustainable access to safe drinking water
- Achieve significant improvement in lives of at least 100 million slum dwellers, by 2020

**Goal 8: Develop a global partnership for development**

- Develop further an open trading and financial system that is rule-based, predictable and non-discriminatory, includes a commitment to good governance, development and poverty reduction— nationally and internationally
- Address the least developed countries’ special needs. This includes tariff- and quota-free access for their exports; enhanced debt relief for heavily indebted poor countries; cancellation of official bilateral debt; and more generous official development assistance for countries committed to poverty reduction
- Address the special needs of landlocked and small island developing States
- Deal comprehensively with developing countries’ debt problems through national and international measures to make debt sustainable in the long term
- In cooperation with the developing countries, develop decent and productive work for youth
- In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries
- In cooperation with the private sector, make available the benefits of new technologies— especially information and communications technologies

## How much will it cost to meet the MDGs?

In 2001, the UN Zedillo commission estimated that an additional US\$50 billion would be required every year to help reach the MDGs<sup>256</sup>. Estimates from others, including the World Bank, placed the annual costs in the range of US\$50 billion - US\$75 billion<sup>257</sup>.

The UN Millennium Project has recently estimated that meeting the MDGs will cost US\$121 billion in 2006 rising to US\$159 billion 2010 through to US\$189 billion in 2015 which will need overseas development aid (ODA) to nearly double to US\$195 billion in 2015<sup>258</sup>.

## Is the cost being met?

Even accounting for the recent increases in ODA and the commitments made by the G-8 and the European Union, there is likely to be an annual shortfall of at least about US\$50 billion even under optimistic scenarios.

The MDGs and other development goals cannot be met by aid inflows alone. There is a need to go back to the UN Monterrey Consensus which placed the mobilization of domestic resources at the heart of the development agenda<sup>259</sup>.

## The MDGs are off-track

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256 United Nations "Report of the High Level Panel on Financing for Development" (Zedillo Report) 2001.

257 [http://www2.undg.org/documents/3018-Overview\\_of\\_MDG\\_Costing\\_Methodologies\\_-\\_Literature\\_review.doc](http://www2.undg.org/documents/3018-Overview_of_MDG_Costing_Methodologies_-_Literature_review.doc)

258 Jeffery Sachs, John McArthur & Guido Schmidt-Traub, *What it will take to meet the Millennium Development Goals*, Sustainable Development International 2005

259 [http://www.un.org/esa/ffd/Monterrey/Monterrey\\_per\\_cent20Consensus.pdf](http://www.un.org/esa/ffd/Monterrey/Monterrey_per_cent20Consensus.pdf)

Despite the rhetoric surrounding the MDGs, to date less than half the ODA resources needed to meet the MDGs have materialized. This problem of insufficient ODA has been compounded by problems in the mobilization of domestic resources owing to increasing tax evasion, aggressive tax avoidance, harmful tax competition, poor fiscal policies and capital flight.

According to the UN, sub Saharan Africa, the poorest region in the world which also has the lowest human development indicators, is not on track to meet any of the MDGs. In fact, of the 18 indicators measured by the UN 11 have shown no change or worse have deteriorated. South Asia is also off track on 14 of the 18 indicators. Even in Latin America and the Caribbean about half of the indicators are off track<sup>260</sup>.

## The way forward

It is important to note that the MDGs are not an end goal in themselves but merely a small step towards tackling poverty in the poorest countries in the world. Even when the MDG targets are met, more than 658 million people will still be living in abject poverty, 520 million will be severely undernourished and 1,827 million will have to make do without access to proper sanitation facilities<sup>261</sup>.

This means much more needs to be done beyond reaching these goals to set countries on a sustainable path to development and this will require resources which are an order of

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260 <http://mdgs.un.org/unsd/mdg/Resources/Static/Products/Progress2006/MDGProgressChart2006.pdf>

261 Jeffery Sachs, John McArthur & Guido Schmidt-Traub, 2005, *ibid*



magnitude greater than the hundreds of billions required just to meet the MDGs. That is why the recommendations made in this report are so important.



## Appendix 2

### Corporate tax rates

<b>Corporation tax rate data</b>									
	1997	1998	1999	2000	2001	2002	2003	2004	Change
Average tax rate (%)	33.3	32.9	31.9	31.7	31.1	30.3	29.8	29.1	4.3
Weighted average based on GDP of country	34.0	33.3	32.3	32.0	31.4	30.4	29.8	29.2	4.8
Average rate of tax in the EU (%)	37.2	36.2	35.5	34.8	33.5	32.0	31.3	30.8	6.4
Average rate of tax in the OECD (%)	36.4	35.7	34.6	33.8	32.7	31.1	30.6	29.7	6.7
Average rate of tax in non OECD (%)	29.5	30.5	29.4	30.1	29.8	29.6	29.1	28.6	0.9
Average rate of tax in large countries (%)	35.4	34.7	34.4	34.2	33.1	32.6	32.1	31.4	4.1
Average rate of tax in small countries (%)	31.3	31.1	29.3	29.2	28.9	27.8	27.4	26.7	4.6
Average rate of tax in countries with high GDP per head (%)	35.7	34.7	34.0	33.1	32.2	30.7	29.8	29.5	6.3
Average rate of tax in countries with low GDP per head (%)	31.4	31.4	29.9	30.5	30.2	29.9	29.7	28.8	2.6
Average rate of tax in country with high state spending (%)	35.9	35.0	34.2	33.5	32.0	30.4	30.0	29.5	6.4
Average rate of tax in country with low state spending (%)	31.8	31.6	30.3	30.6	30.6	30.1	29.6	28.8	2.9
Maximum rate (%)	53.2	51.6	48.0	47.2	42.1	42.0	42.0	42.0	11.2
Minimum rate (%)	15.0	15.0	15.0	15.0	15.0	16.0	12.5	12.5	2.5
Number of companies in survey	60	62	61	65	68	69	69	69	
Maximum rate cut in year (%)	n/a	12.0	21.3	9.0	15.0	15.0	13.0	10.0	
Maximum rate rise in year (%)	n/a	5.0	8.0	10.0	11.3	7.0	6.0	3.0	
Number of cuts in year	n/a	10	14	12	17	17	13	15	
Number of rises in year	n/a	2	4	5	5	4	7	3	
Net number of cuts per annum	n/a	8	10	7	12	13	6	12	

Data prepared by Richard Murphy. Sources: KPMG Corporate Tax Rate Surveys 1997 - 2005 <http://www.kpmg.com/Services/Tax/IntCorp/CTR/> and the CIA World Fact Book

## Appendix 3

### The world's tax havens and the firms that operate in them

Tax Havens	Total Havens	KPMG 1	KPMG 2	E&Y 1	E&Y 2	PWC 1	PWC 2	Deloitte 1	Deloitte 2
<b>Major Financial Centres</b>									
Belgium		1	1	1	1	1	1	1	1
City of London		1	1	1	1	1	1	1	1
Frankfurt		1	1		1	1	1	1	1
Hong Kong		1	1	1	1	1	1	1	1
Netherlands		1	1	1	1	1	1	1	1
New York		1	1	1	1	1	1	1	1
South Africa		1	1	1	1	1	1	1	1
Switzerland		1	1	1	1	1	1	1	1
Tel Aviv		1	1	1	1	1	1	1	1
<b>Sub Total: Major Financial Centres</b>	<b>9</b>	<b>9</b>	<b>9</b>	<b>8</b>	<b>9</b>	<b>9</b>	<b>9</b>	<b>9</b>	<b>9</b>
<b>Premier Havens</b>									
British Virgin Islands		1	1	1	1	1	1	1	1
Cayman Islands		1	1	1	1	1	1	1	1
Cyprus		1	1	1	1	1	1	1	1
Dubai		1	1	1	1	1	1	1	1
Guernsey		1	1	1	1	1	1	1	1
Ireland		1	1	1	1	1	1	1	1
Isle of Man		1	1	1	1	1	1	1	1
Jersey		1	1	1	1	1	1	1	1
Liechtenstein		1	1		1	1	1	1	1
Luxembourg		1	1	1	1	1	1	1	1
Singapore		1	1	1	1	1	1	1	1
The Bahamas		1	1	1	1	1	1		1
<b>Sub Total: Premier Havens</b>	<b>12</b>	<b>12</b>	<b>12</b>	<b>11</b>	<b>12</b>	<b>12</b>	<b>12</b>	<b>11</b>	<b>12</b>
<b>Mid-range Havens</b>									
Aruba		1	1	1	1	1	1	1	1
Bahrain		1	1	1	1	1	1	1	1
Barbados		1	1	1	1	1	1	1	1
Bermuda		1	1	1	1	1	1	1	1
Costa Rica		1	1	1	1	1	1	1	1
Dominica		1	1		1	1	1		
Gibraltar			1			1	1	1	1
Hungary		1	1	1	1	1	1	1	1
Iceland		1	1	1	1	1	1	1	1

Labuan		1	1	1	1	1	1	1	1
Lebanon		1	1	1	1	1	1	1	1
Macau		1	1		1	1	1	1	1
Malta		1	1	1	1	1	1	1	1
Mauritius		1	1	1	1	1	1	1	1
Netherlands Antilles			1		1	1	1	1	1
Panama		1	1	1	1	1	1	1	1
Taipei		1	1	1	1	1	1	1	1
Turks & Caicos Islands		1	1			1	1		
Uruguay		1	1	1	1	1	1	1	1
US Virgin Islands			1			1			
<b>Sub Total: Mid-range Havens</b>	<b>20</b>	<b>17</b>	<b>20</b>	<b>14</b>	<b>17</b>	<b>20</b>	<b>19</b>	<b>17</b>	<b>17</b>
<b>Minor Havens</b>									
Andorra		1							
Anguilla		1	1						
Antigua & Barbuda		1	1			1	1		
Belize			1		1				1
Grenada					1	1	1		1
Madeira		1	1		1				1
Monaco					1			1	
Saint Lucia		1	1		1	1	1		
Saint Vincent & the Grenadines		1	1		1				
St Kitts & Nevis					1	1	1		
The Cook Islands		1	1						1
The Maldives		1	1		1	1	1		
Trieste		1	1		1	1	1		
<b>Sub Total: Minor Havens</b>	<b>13</b>	<b>9</b>	<b>9</b>	<b>0</b>	<b>9</b>	<b>6</b>	<b>6</b>	<b>1</b>	<b>4</b>
<b>Notional Havens</b>									
Alderney									
Campione d'Italia									
Ingushetia									
Liberia									
Marshall Islands								1	1
Melilla									
Montserrat									
Nauru									
Niue									
Samoa									
Sao Tome e Principe									
Sark									
Somalia									
The Marianas					1			1	1
The Seychelles			1						
Tonga									
Turkish Republic of Northern									

Cyprus									
Vanuatu									
<b>Sub Total: Notional Havens</b>	<b>18</b>	<b>0</b>	<b>1</b>	<b>0</b>	<b>1</b>	<b>0</b>	<b>0</b>	<b>2</b>	<b>2</b>
<b>Total</b>	<b>72</b>	<b>47</b>	<b>51</b>	<b>33</b>	<b>48</b>	<b>47</b>	<b>46</b>	<b>40</b>	<b>44</b>

Source: Tax Havens from Tax Us if You Can, a TJN publication.

Source: Accountancy and Audit firms column "1" from firm's own websites.

Source: Accountancy and Audit firms column "2" from Google search engine.

Research undertaken by Chris Steel BSc, ATTAC and TJN Jersey <http://www.jersey.attac.org/>

## Appendix 4

WORLD SOCIAL FORUM, NAIROBI, KENYA, JANUARY 2007

# MIRROR, MIRROR ON THE WALL, WHO'S THE MOST CORRUPT OF ALL?

John Christensen

### Abstract

The current pre-occupation of the World Bank and G-8 countries with corruption and money-laundering is based on a narrow definition of both issues, which ignores the role of the offshore financial system in encouraging and facilitating capital flight and tax evasion. In focusing their agenda on bribery of public officials, these institutions have shaped perceptions of corruption around the concerns of multinational companies, which, driven by the pursuit of profit, want to reduce the 'cost' of bribery, but are unconcerned about the wider costs to society arising from their own aggressive tax avoidance policies and the broader economic impact of the globalised banking industry which encourages rich individuals to hold their assets offshore where they can evade taxes with almost total impunity.

This paper examines how ideological factors have shaped the geography of the corruption discourse to identify developing countries, particularly in Africa, as the primary locus of corruption, whilst concerns about how the prevailing financial infrastructure profits from handling the proceeds of criminal activity, including tax evasion, Closing the Floodgates

have been consistently ignored. The paper concludes with a number of recommendations for how perceptions of corruption can be re-aligned to take account of how 'supply side' factors influence global corruption.

### Corruption: a game for two or more players

Since the mid-1990s corruption has moved to the centre stage of global politics. In 1995 Transparency International (TI) launched its international Corruption Perception Index (CPI) which encouraged the international media to give greater prominence to corruption whilst also exerting pressure on politicians, banks and international funding agencies to rank corruption amongst the core criteria for assessing credit risk and aid-worthiness. That same year, in its year-end editorial the *Financial Times* nominated 1995 the International Year of Corruption and identified the issue as a major impediment to cross-border investment and growth. Since that time a plethora of initiatives have been set in motion at the highest levels to tackle corrupt practices, most notably the OECD's Anti-Bribery Convention (1999) and the UN Convention Against Corruption (2003). Corruption has become a central feature of the development

discourse, with key players, including the International Monetary Fund, the World Bank and the UK Department for International Development, identifying corruption as an impediment to growth and stability.<sup>262</sup> Corruption is also increasingly seen as threatening equality and social stability, harming public trust in state institutions and governance,<sup>263</sup> and damaging public confidence in business integrity.<sup>264</sup>

The deepening of globalised markets since the 1970s is seen as having increased the opportunities for corruption. The emergence of globalised corporations with huge financial and political power relative to national governments has provided additional resources for high-level corruption. The rapid pace of transfer of state assets to private ownership in North and South created opportunities for embezzlement of both assets and the income flows from those assets. The globalisation of financial markets, and in particular the creation of a poorly regulated globalised structure of secretive offshore financial centres, has facilitated the cross-border transfer and laundering of dirty money. In combination these factors have stimulated a virtual free-for-all in which illegal transactions have become almost indistinguishable from legitimate transactions, and criminals are able to draw upon the services of a sophisticated 'pinstripe infrastructure' of legal and financial advisers.

<sup>262</sup> See, for example, Kaufmann, D (1997) **The Missing Pillar of a Growth Strategy for Ukraine: Reforms for Private Sector Development** in Cornelius, P. and Lenain, P. (eds) *Ukraine: Accelerating the Transition to Market*, IMF, Washington

<sup>263</sup> See **The Fight Against Corruption**, Pontifical Council for Justice and Peace, 21 September 2006

<sup>264</sup> Hutton, W. (2005) **The monster within us all**, Editorial Comment, *The Observer*, 26 June

Crime has become increasingly complex, frequently involving cross-border transactions based on the arbitrage of differences between national legal or tax regimes. The relative ease with which such crimes can be perpetrated undermines public confidence in the rule of law, and corrodes the integrity of democratic forms of government. Some commentators identify the source of this high-level corruption as stemming from the divergence of capitalism away from the moral philosophy upon which Adam Smith based his vision of free, competitive markets towards the utilitarian ideas of Jeremy Bentham:

*" . . . his (Smith's) vision for this new economic order anticipated leaders of integrity, prudence, modesty and grace who would operate the free-market system with a sense of justice and fair play. Unfortunately, Smith's moral sentiments got separated from his economics. The greatest good for the greatest number - "maximising" - became the foundation of utilitarianism, a competing school of thought much more compatible with budding capitalists."*<sup>265</sup>

Economic theory about corruption is underdeveloped and consequently tends not to take account of the way in which economic policies can create 'criminogenic environments' which stimulate crime.<sup>266</sup> This is illustrated by the rapid growth of tax evasion which swelled in the wake of capital account liberalisation in the 1980s. The IMF promoted capital account liberalisation despite the evidence that offshore secrecy would hinder investigation

<sup>265</sup> Baker, R.W. & Nordin, J. **How dirty money thwarts capitalism's true course** *Financial Times*, 11 October 2005

<sup>266</sup> Black, W.K. (2005) **When Fragile Becomes Friable: Endemic Control Fraud as a Cause of Economic Stagnation and Collapse** paper given at the IDEAS Workshop, New Delhi, India, 19-20 December



efforts and make tax evasion virtually undetectable, especially in the case of developing countries with limited resources available for tax fraud detection. Predatory financial intermediaries recognised that profitable fees could be earned from selling tax dodging services on an industrial scale, and a culture of 'crime pays' became rampant. The intriguing question is whether the IMF anticipated this outcome but considered tax evasion a minor evil or whether this was an unintended consequence of its commitment to the Washington Consensus.

The incidence of tax evasion, and the scale of its impact on the revenue income of poorer countries, has risen significantly in the past three decades, but for the greater part this crime is scarcely recognised by those who have shaped the current corruption debate. The reason for this omission might partly arise from the general adoption of TI's definition of corruption as "*the misuse of entrusted power for private gain.*"<sup>267</sup> Operationally this definition has been interpreted in a way which largely focuses on the activities of those who hold power in the public sphere (politicians and state employees) and little attention has been paid to other power elites, including company directors, and financial intermediaries.

It is debatable whether TI intended to shape the corruption debate in this way, but the tendency to treat corruption as synonymous with bribery of public sector officials is partly due to the methodology of the CPI, which draws on the perceptions of businesses and a narrow range of think tanks. Unsurprisingly this community has tended to concentrate on those areas of corruption which impose a

cost on business, bribery and kickbacks being the foremost issue of concern in this respect, without paying attention to issues such as tax evasion and trade mispricing which involve business imposing costs on the rest of society. Concerns have been expressed about the methodological biases of the CPI,<sup>268</sup> and critics argue that the index distorts the geography of corruption by reinforcing negative images of developing countries and ignoring the higher level corruption of major companies and governments from the North.<sup>269</sup>

The CPI identifies Africa as the most corrupt region of the world, accounting for over half of the 'most corrupt' quintile of countries in the 2006 index. A critical examination of the index, however, reveals that 53 per cent of the countries identified by the CPI as 'least corrupt' are offshore tax havens, including Iceland and New Zealand (minor players but both ranked joint 1<sup>st</sup> overall) and major centres such as Singapore (ranked 5<sup>th</sup> overall), Switzerland (7<sup>th</sup>), United Kingdom and

<sup>267</sup>

[www.transparency.org/news\\_room/faq/corruption\\_faq](http://www.transparency.org/news_room/faq/corruption_faq)

<sup>268</sup> See, for example, Galtung, F. (2006) *Measuring the Immeasurable: Boundaries and Functions of (Macro) Corruptions Indices*, in Sampford, C. et al (eds), *Measuring Corruption*, Ashgate Publishing

<sup>269</sup> Christensen, J. (2006) *Corruption and the role of tax havens*, *Tax Justice Focus*, Volume 2, No. 3, pp7-8

Luxembourg ( joint 11<sup>th</sup>), Hong Kong (15<sup>th</sup>), Germany (16<sup>th</sup>), USA and Belgium (jointly 20<sup>th</sup>). For good measure Barbados, Malta, and the United Arab Emirates (all tax havens) also fall into the 'least corrupt' quintile. Not a single African nation is ranked in the 'least corrupt' quintile.

What do these rankings tell us about the current politics of corruption? And who could disagree with the former Nigerian politician who, during protracted negotiations to secure the repatriation of assets stolen by former Nigerian President Sani Abacha, commented that:

*It is rather ironical that the European based Transparency International does not think it proper to list Switzerland as the first or second most corrupt nation in the world for harbouring, encouraging and enticing all robbers of public treasuries around the world to bring their loot for safe-keeping in their dirty vaults.*<sup>270</sup>

The perversity of the CPI rankings reflects the general confusion and inadequacy of the current corruption discourse. Through its operational focus on the public sector, and its dependence on the perception of a somewhat biased range of actors - at least some of whom have conflicts of interest - the CPI highlights one element of corruption without paying sufficient attention to other aspects of corruption, including:

- Ø the activities of the supply side infrastructure of financial intermediaries who market aggressive tax dodging schemes and facilitate the laundering of the proceeds of crime through offshore companies, trusts and similar subterfuges; and
- Ø the role of governments which actively collude in the process of

encouraging illicit capital flight and tax evasion by offering secretive offshore facilities and soft regulation.

Trying to broaden the terms of debate upon which perceptions of corruption are shaped is not merely an issue of semantics. Corruption is a politically contested issue, defined according to the "*legal or social standards constituting a society's system of public order.*"<sup>271</sup> Cultural norms diverge significantly, for example in the way in which commissions are paid in return for high-level introductions, and although a process of convergence is underway, which might ultimately allow the formulation of a globally agreed definition of corruption, this is not likely in the foreseeable future.<sup>272</sup> In view of these definitional complexities, some commentators argue that debate over definition might be counter-productive, proposing instead that the focus of anti-corruption initiatives should be less concerned with identification of an all-embracing definition and more concerned with pin-pointing the specific activities which contribute to the undermining of public confidence in the integrity of the systems of governance of public and private sector activity.<sup>273</sup> One critic argues that the CPI fails to fulfil a useful role in shaping the corruption discourse, concluding that:

*. . . it (the CPI) should no longer be published in its present form as it actually undermines the efforts of reformers.*<sup>274</sup>

<sup>271</sup> Philp, M. (2006) **Corruption Definition and Measurement**, in Sampford, C. et al (eds), *Measuring Corruption*, Ashgate Publishing

<sup>272</sup> See Brown, A. J. (2006) **What are we trying to measure? Reviewing the basics of corruption definition**, in Sampford, C. et al, *Measuring Corruption*, Ashgate Publishing

<sup>273</sup> Miller, W.L. (2006) **Perceptions, Experiences and Lies: What Measures Corruption and What do Corruption Measures Measure?** in Sampford, C. et al, *Measuring Corruption*, Ashgate Publishing

<sup>274</sup> Galtung, F (2006) op cit

<sup>270</sup> Former Education Minister Professor Aliya Babs Fafunwa quoted in *This Day*, 6<sup>th</sup> June 2005

These criticisms of the CPI challenge its legitimacy as the lead indicator used by multilateral institutions and private banks when determining the credit ratings of sovereign states. In its current format the CPI creates a distorting prism from which the activities of tax havens (most of which are closely linked to leading industrialised countries) are excluded. This bias might or might not be derived from an ideological slant within TI itself, but the CPI's deficiencies are sufficiently grave for its methodology, and the uses to which it is put, to be called into question. Disquiet about the CPI is not diminished by the close involvement of multinational audit and accounting firm Ernst & Young in its production. Ernst & Young has itself been implicated in a wide variety of corruption cases, and operates in many offshore tax havens.<sup>275</sup>

TI is aware of the shortcomings of its index. In the press documentation accompanying the results of the 2006 CPI, TI noted that:

*. . . the [corrupt] transaction is often enabled by professionals from many fields. Corrupt intermediaries link givers and takers, creating an atmosphere of mutual trust and reciprocity; they attempt to provide a legal appearance to corrupt transactions, producing legally enforceable contracts; and they help to ensure that scapegoats are blamed in case of detection.*<sup>276</sup>

It has yet to be seen, however, whether and how TI can adapt the CPI to create an international comparator index (or indices) which encompasses these broader concerns about corruption.

<sup>275</sup> See TJN's blog on Ernst & Young's involvement in the CPI at: <http://taxjustice.blogspot.com/2006/09/perceptions-whose-perceptions.html>

<sup>276</sup> Downloaded from [http://www.transparency.org/news\\_room/in\\_focus/cpi\\_2006#pr](http://www.transparency.org/news_room/in_focus/cpi_2006#pr) on 2<sup>nd</sup> January 2007

## The political economy of the offshore system

It is impossible to conceive of the possibility of combating corruption without also tackling the broader issues of tax havens and the offshore economy. Tax havens provide an 'corruption interface' between the illicit and licit economies. They distort global markets to the disadvantage of innovation and entrepreneurship; slow economic growth by rewarding free-riding and mis-directing investment; and increase global inequality. The corruption interface functions through collusion between private sector financial intermediaries and the governments of states which host offshore tax haven activities. The majority of these states are major developed nations and their dependent territories. Despite the evocative images conjured up by the term 'offshore', it would be wrong to think of offshore as disconnected and remote from mainstream nation states.

Geographically, the majority of the 70 or so recognised offshore tax havens are located on small island economies dispersed across the spectrum of time zones. From a political economic perspective, however, these tax havens are inextricably linked to major OECD states, and the term 'offshore' is strictly a political statement about the relationship between the state and parts of its related territories.<sup>277</sup> In the British economy, for example, the bulk of offshore transactions are controlled by the City of London (also classified as a tax haven) albeit that many City financial intermediaries operate out of centres located on UK Overseas Territories and Crown Dependencies. These centres have a tangible form, with quasi independent fiscal and judicial systems, functional banks, trust companies and law offices, but in

<sup>277</sup> Palan, R., (1999) op cit

practice they do not function autonomously from the mainstream economies. They are primarily of use to the City because they offer zero or minimal tax rates combined with secrecy arrangements (including non-disclosure of beneficial ownership of companies and trusts) and regulatory regimes which are more permissive or less inquisitive than those prevailing in onshore economies.<sup>278</sup>

The defining feature of the offshore interface is the element of secrecy it provides, either through banking secrecy laws or through *de facto* judicial arrangements and banking practices. Secrecy creates an effective barrier to investigation by external authorities,<sup>279</sup> and facilitates the laundering of proceeds from a wide range of criminal activities, including fraud, embezzlement and theft, bribery, narco-trafficking, illegal arms-trafficking, counterfeiting, insider trading, false trade invoicing, transfer mispricing, and tax evasion. This reveals a major fault line in the financial liberalisation process. Whilst capital has become almost totally mobile, the ability to police cross-border dirty money movements is hindered by the lack of cooperative arrangements between national authorities. This applies in particular to attempts to tackle tax evasion. There are a number of reasons for this. Firstly, by definition capital flight involves illicit cross-border transfers which almost invariably lead to tax evasion in the country of residence of the beneficial owner. However, tax

evasion is not generally included in definitions of money-laundering despite the fact that it involves criminal activity. We must ask ourselves why not? Secondly, the initiative by the OECD to tackle tax evasion through information exchange agreements has not succeeded to anywhere near the extent that was originally expected; ditto the European Savings Tax Directive, which since coming into force in July 2005 has failed to meet initial expectations.

The cause of these failures lies not with technical problems, which are surmountable, but with the lack of political will to achieve an international framework for cooperation. The unsurprising outcome has been a massive increase in cross-border dirty money flows, conservatively estimated at US\$1 trillion annually.<sup>280</sup> Half of this dirty money originates from developing countries. The vast majority of these funds are laundered via complex offshore ladders operating through the global banking system. Despite a plethora of anti-money-laundering initiatives the failure rate for detecting dirty money flows is astonishingly high, with one Swiss banker estimating that only 0.01 per cent of dirty money flowing through Switzerland is detected.<sup>281</sup> It is unlikely that other major offshore finance centres, including Frankfurt, London and New York, are any better.

Many major companies are heavily implicated in the establishment of complex offshore financial systems explicitly designed to hinder legitimate investigation by national authorities. Experienced investigators refer to purposeful obstruction, even in cases where there is overwhelming evidence of criminal activity. For example, Patrick

<sup>278</sup> The British Channel Island of Jersey exemplifies this more permissive regime. The 2005 IMF inspection identified a problem with the lack of investment into financial crimes investigation, but no additional resource has been allocated since that time [Herbert, C., (2007) Jersey 'lagging behind' in financial crime laws, *Jersey Evening Post*, 4<sup>th</sup> January]

<sup>279</sup> Christensen, J. and Hampton, M.P. (1999) op cit

<sup>280</sup> Baker, R., (2005) op cit, p172

<sup>281</sup> Baker, R. (2005) op cit, p174

Smith, editor of *Africa Confidential*, alleges in the context of illegal oil bunkering and corruption in Nigeria that oil companies or their accountants sometimes maintain “two sets of accounts. They will show you the set of accounts they want the government and officials to see. There will be another one locked away.”<sup>282</sup>

Over one half of global cross-border trade is routed on paper through tax havens, and about one-third of the assets of the global rich are held in offshore structures. The scale of the offshore interface is therefore immense, though many economists nonetheless overlook offshore in their analysis, which might explain their inability to explain the ‘uphill’ movement of capital from poor to rich nations despite the predictions of economic theory.<sup>283</sup> The prospect of financial crises might be a primary cause of capital flight, but offshore secrecy creates a strong incentive for the rich in developing countries to retain their assets in a tax-free environment. Most analysts agree that the awesome scale of capital flight from Africa, estimated by the African Union at US\$148 billion annually, results in a permanent drain of between 80 - 90 per cent of the capital to offshore financial centres in Europe, the Caribbean or North America.<sup>284</sup> A study of Sub-Saharan African countries, for example, has concluded that the region is a net creditor to the rest of the

world in the sense that its external assets (i.e. including the stock of flight capital) exceeds external liabilities (i.e. external debt).<sup>285</sup> The chronic poverty that afflicts the region arises from the fact that the assets are largely held in private hands<sup>286</sup>, whilst the liabilities have been assigned to the African public.

In March 2005 the TJN published a briefing paper which estimated the stock of private wealth held ‘offshore’ by rich individuals, and largely undeclared in the country of residence, at about US\$11.5 trillion.<sup>287</sup> The annual worldwide income on these undeclared assets is estimated at about US\$860 billion, and the annual worldwide tax revenue lost on such undeclared income is about US\$255 billion. This figure significantly exceeds the sums needed to finance the UN’s Millennium Development Goals. Whilst the majority of this US\$11.5 trillion of undeclared assets originates from developed countries, a significant proportion comes from developing countries. For example, over 50 per cent of the cash and listed securities of rich individuals in Latin America is reckoned to be held offshore.<sup>288</sup> Data for Africa are scarce, but most analysts assume the ratio to be comparable to Latin America or higher. The African Union, for

<sup>282</sup> Rowell, A., Marriott., and Stockman, L. (2005) *The Next Gulf: London Washington and Oil Conflict in Nigeria*, Constable, London

<sup>283</sup> Guha, K. (2006) **GLOBALISATION - A share of the spoils: why policymakers fear ‘lumpy’ growth may not benefit all**, *Financial Times*, 28 August, p11

<sup>284</sup> Raymond Baker from the Global Financial Integrity program (Washington, D.C.), quoted from oral evidence given to the UK Africa All Party Parliamentary Group in January 2006.

<sup>285</sup> Boyce, J.K. and Ndikumana, L. (2005) **Africa’s Debt: Who Owes Whom?** In Epstein, G.A. **Capital Flight and Capital Controls in Developing Countries**, Edward Elgar, Cheltenham

<sup>286</sup> For example, in November 2006 members of the Angolan opposition party Partido Democrático para Progreso demonstrated outside the French embassy in Luanda accusing government officials of hiding “billions of dollars . . . on the Côte d’Azur.” [Thompson, C., *Diary*, London Review of Books, volume 29, No.1 4<sup>th</sup> January 2007]

<sup>287</sup> [http://www.taxjustice.net/cms/upload/pdf/Price\\_of\\_Offshore.pdf](http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf)

<sup>288</sup> Boston Consulting Group (2003) **Global Wealth Report**



example, has estimated capital flight from the Sub-Saharan region at US\$274 billion, equivalent to 145 percent of the total regional external debt.<sup>289</sup> This loss easily eclipses the value of aid and debt relief promised to African leaders at last year's G-8 summit at Gleneagles.

But the figure of US\$255 billion in tax revenue lost to tax evasion on assets held offshore is only one part of the equation. Developing countries also lose out to tax evasion in the domestic context (often from activities in the informal economy), from tax avoidance on cross-border trade, and from the pressures to compete for investment capital through offering unnecessary tax incentives. In combination these issues are estimated to cost developing countries approximately US\$385 billion annually in tax revenues foregone.<sup>290</sup> This clearly represents a massive haemorrhaging of the financial resource of many developing countries, which undermines sustainability in a variety of ways:

- § Declining tax revenue income from the wealthy and high income earners forces governments to substitute other taxes (typically indirect) with a consequent regressive impact on wealth and income distribution;
- § Falling tax revenues force cutbacks in public investment in education, transport and other infrastructure;
- § Tax dodging creates harmful market distortions, rewarding economic free-riders and penalising those who follow ethical practice;

<sup>289</sup> See UK Africa All Party Parliamentary Group (2006) *The Other Side of the Coin: The UK and Corruption in Africa*, p14

<sup>290</sup> Cobham, A. (2005) *Tax Evasion, Tax Avoidance and Development Finance* Queen Elizabeth House Working Paper Series No. 129, Oxford

- § Tax dodging undermines public respect for the rule of law and the integrity of democratic government.

The scale of tax dodging in poorer countries has stimulated a vicious circle of decline in investment in public services like education and vocational training, reducing their attractiveness to both domestic and foreign investors. In its latest report on Latin America, the World Bank argues that governments must give higher priority to spending on infrastructure likely to benefit the poor and increase expenditure on education and healthcare. In practice a large proportion of government spending in Latin America is skewed in favour of the well off, and governments are collecting far too little tax, especially from the wealthy. The World Bank report concludes that: *"on the tax front, first items in the agenda would be strengthening anti-tax evasion programs and addressing the high levels of exemptions."*<sup>291</sup>

Crucially the techniques used for tax dodging and laundering dirty money involve identical mechanisms and financial subterfuges: tax havens, offshore companies and trusts, foundations, correspondent banks, nominee directors, dummy wire transfers, and an absence of financial transparency. Legal institutions granted special status and privilege by society have been subverted to purposes for which they were never intended. For example, the original purpose of trusts was to promote the protection of spouses and other family members who are unable to look after their own affairs, and to promote charitable causes. Incredible as it must appear to those not familiar with the offshore economy,

<sup>291</sup> Lopez, J.H. et al (2006) *Poverty Reduction and Growth: Virtuous and Vicious Circles*, The World Bank, p101



charitable trusts are regularly set up in offshore tax havens for the purposes of owning 'special purpose vehicles' used for international tax planning and for hiding both assets and liabilities offshore, as happened with Enron, Parmalat and Worldcom.<sup>292</sup>

Many examples can be cited of how the offshore system has been constructed to encourage corrupt activities and distort global markets.<sup>293</sup> Some of the smaller tax havens have played a lead role in this process, partly because the scale of their legislatures makes it easier for major banks and accounting firms to influence the political processes and secure favourable regulatory and fiscal treatments.<sup>294</sup> Economically vulnerable small island economies (SIEs) are particularly easy for global capital to capture in this way because of the small scale of their governments and the lack of separation of legislative and judicial processes.<sup>295</sup> As a result, SIEs have often been prepared to enact new measures to promote tax and regulatory competition on behalf of the organised tax avoidance industry. The British Channel Island of Jersey, for example, introduced a new trust law in May 2006 which allows the creation and operation of 'sham' trusts which can only serve the purposes of tax

dodgers.<sup>296</sup> The law appears to serve no other purpose. Jersey is a dependency of the British Crown and this law would have been presented to the Privy Council for approval prior to its enactment. Since these 'sham' trusts will largely be created on behalf of high net-worth people from outside the island, it is clear that the UK government is not serious about tackling the global tax dodging industry.

The United Kingdom is often seen as a key player in promoting the offshore interface and thereby sustaining the supply side of globalised corruption. This assessment is based on a number of aspects of British economic policy which undermine public confidence in the integrity of government policy and are ultimately harmful to national and international interests. These are:

- § Britain's domicile rules which provide preferential treatment to high net wealth persons resident but claiming non-domiciled status in Britain;
- § Britain's role as a defender of the tax haven activities of its overseas territories and Crown dependencies, including the continued abuse of European VAT rules by the Channel Island based fulfilment industry;
- § Britain's extensive use of tax competition to gain international advantage, e.g. the tax free status of the London Eurobond market;
- § Britain's refusal to engage with other European Union members in defining a common basis for taxing multinational businesses;

<sup>292</sup> Brittain-Catlin, W., (2005) *Offshore: The Dark Side of the Global Economy*, Farrar, Strauss and Giroux, New York, pp55-76

<sup>293</sup> See Sikka, P. et al (2002) *No Accounting for Tax Havens*, AABA, Basildon, England

<sup>294</sup> See Palan, R., (1999) *Offshore and the Structural Enablement of Sovereignty*, in Hampton, M.P., & Abbott, J.P., . (eds) *Offshore Finance Centres and Tax Havens: The Rise of Global Capital*, MacMillan, Basingstoke.

<sup>295</sup> Christensen, J. and Hampton, M.P. (1999) *A Legislature for Hire: The Capture of the State in Jersey's Offshore Finance Centre*, in Hampton, M.P. & Abbott, J.P., op cit

<sup>296</sup> For further detail and analysis see: [www.taxresearch.org.uk/Blog/2006/06/15/jersey-passes-law-allowing-per-cente2-per-cent80-per-cent98sham-per-cente2-per-cent80-per-cent99-trusts-for-use-by-tax-evaders/](http://www.taxresearch.org.uk/Blog/2006/06/15/jersey-passes-law-allowing-per-cente2-per-cent80-per-cent98sham-per-cente2-per-cent80-per-cent99-trusts-for-use-by-tax-evaders/)

§ Britain's role in undermining the effectiveness of the European Union's Savings Tax Directive by failing to advise the European Commission that the directive as agreed would allow interest paid to trusts to fall outside the tax deduction provisions. This omission appears to have been deliberate and has left a massive loophole in the Savings Tax Directive.<sup>297</sup>

Furthermore many of the legal subterfuges that play a part in the offshore interface have their origins in British law. This includes offshore trusts and shell companies, and the long standing concept of the separation of the place of incorporation of a company and the obligation to pay tax. The latter concept remains a key element of offshore tax planning. Britain, therefore, could play a major role in tackling the supply side of corruption, but successive governments have baulked at the task. We must ask ourselves why this been the case and, more generally, why: *"The whole culture of Anglo-American finance is increasingly subversive of regulation, taxation and democratic values, even when it remains within the law."*<sup>298</sup> The root of this problem might partly lie with the unhealthy proximity between major financial intermediation businesses and key Whitehall departments, including and especially the Treasury, and the extent to which the main political parties have become dependent on donations - including staff secondments - from the corporate world. Overall, it is hard to avoid the conclusion that when it comes to the provision of the enabling

infrastructure for high level corruption Britain is a lead player.

### Pinstriped subversion

*I have to challenge some of my own inherited perceptions that London is safe, Lagos is not. Britain is free of corruption, but Nigeria is not. Much of the corruption stems from London and Washington. Many of the mechanisms that keep Nigerians poor - the networks of offshore bank accounts that companies use to bleed Nigeria dry of its profits - are based in tax havens that were set up by the British and other colonial powers.*<sup>299</sup>

Tax dodging corrupts the revenue systems of the modern state and undermines the ability of the state to provide the services required by its citizens. It therefore represents a higher form of corruption because it directly deprives society of its legitimate public resource and undermines public trust in the rule of law and the equity of the tax system. Tax dodgers include institutions and individuals who enjoy privileged social positions but see themselves as an elite detached from normal society and reject *"any of the obligations that citizenship in a normal polity implies"*.<sup>300</sup> This group comprises the rich and high income earners, plus a pinstripe infrastructure of professional bankers, lawyers, and accountants, with an accompanying offshore infrastructure of tax havens with quasi-independent polities, judiciaries and regulatory authorities. This type of corruption therefore involves collusion between

<sup>297</sup> Christensen, J., and Murphy, R., (2006) *The Tax Avoider's Chancellor, Red Pepper*, August, pp24-26

<sup>298</sup> Plender, J. (2003) **INSIDE TRACK: Going off the rails**, *Financial Times*, 28<sup>th</sup> January

<sup>299</sup> Rowell, A. (2005) *Changing Perceptions*, in Rowell, A., Marriott., and Stockman, L. *The Next Gulf: London Washington and Oil Conflict in Nigeria*, Constable, London

<sup>300</sup> Reich, R., (1992) *The Work of Nations*, New York

private and public sector actors, who purposefully exploit their privileged status to undermine national tax regimes by facilitating activities which straddle the border line between the legal and the illegal, the ethical and the unethical.

Despite the fact that many of its practitioners hold professional status, the culture of the tax dodging industry is wholly subversive of democratic good practice. This spirit of disdain for public interest is perfectly captured in the following quote given to a national newspaper in response to the 2004 financial statement by the UK Chancellor of the Exchequer: *"Rules are rules, but rules are meant to be broken . . . No matter what legislation is in place, the accountants and lawyers will find a way around it.."*<sup>301</sup> No matter how you attempt to spin this statement, it is clearly intended to convey the message that some classes of society are beyond compliance with social norms. Incredibly, none of the professional institutions of lawyers or accountants promote ethical codes of conduct on the marketing of tax avoidance structures and the use of tax havens by their members. Journalists have also played a role in shaping and perpetuating a degree of ambivalence towards tax dodging, illustrated in the reporting in the western media of the trial of Mikhail Khordorkovsky, former Chief Executive Officer of Russian oil giant Yukos, who was indicted and subsequently found guilty of tax evasion. The evidence presented to the court was overwhelming. The sums involved were massive. There was no question that Yukos executives set out to flagrantly flout the Russian tax laws, indeed former Yukos Chief Finance Officer Bruce Misamore (an American) had told the oil press that the company had *"exercised*

*its constitutional right to manicure its tax affairs."*<sup>302</sup> None of which prevented the western press, much of which is controlled by owners who make extensive use of offshore tax havens, from disregarding the evidence of criminality and treating Khordorkovsky as a victim of political repression.

Accountants enjoy a privileged status in most societies, but they, along with lawyers and bankers, have played a lead role in shaping and promoting offshore facilities for their clients. They typically justify their tax avoidance activities on the basis that their clients are overburdened by the complexity of tax laws, an argument which conveniently skirts around the fact that a significant proportion of this complexity arises from the need for the tax authorities to counter their own aggressive tax avoidance strategies.<sup>303</sup> Some economists also seek to argue the case for tax avoidance on the basis of its promoting economic 'efficiency' - a politically loaded term in almost all uses. However, their models have generally underestimated the regressive impacts of the tax reforms which they promote to improve 'efficiency' and are typically based on closed economies which are wholly removed from the reality of a world of unrestricted capital movements, banking secrecy and tax dodging.

Some practitioners even argue that directors have a duty to dodge tax:

*Tax is a cost of doing business so, naturally, a good manager will try to manage this cost and the risks associated*

<sup>302</sup> Extracted from *Platts OilGram*, 3<sup>rd</sup> December 2003

<sup>303</sup> See Murphy, R. (2006) at [www.taxresearch.org.uk/Blog/2006/12/06/41-of-all-uk-tax-legislation-tackles-tax-avoidance](http://www.taxresearch.org.uk/Blog/2006/12/06/41-of-all-uk-tax-legislation-tackles-tax-avoidance) accessed 15 December 2006

<sup>301</sup> Guy Smith, tax adviser, Moore Stephens, quoted in *The Guardian*, 18<sup>th</sup> March 2004

*with it. This is an essential part of good corporate governance.*<sup>304</sup>

This statement needs careful unbundling to understand its underlying politics. Firstly, a tax on profits is not a business cost but a distribution to society. This much is clear from how tax is reported on the profit and loss account alongside distribution to shareholders. Secondly, the use of the word risk is revealing. What risks arise from tax other than those involving a legal challenge to an avoidance or evasion strategy? Thirdly, directors committed to business integrity might prefer an ethically based approach in which *“the tax-planning industry is encouraged to establish codes of conduct to provide a socially responsible, rather than merely legal, dimension to the tax advice that is offered to transnational corporations.”*<sup>305</sup> Finally, there is no requirement under company law – anywhere in the world – for company directors to avoid tax, especially when this involves actions that might infringe national laws, and hiding these actions from the scrutiny of shareholders and national authorities.

In practice, much offshore tax planning involves practices which most citizens would not regard as good corporate governance. Hence the secrecy in which these practices are conducted. In the words of the report on tax havens published by the U.S. Senate in August 2006:

*Utilizing tax haven secrecy laws and practices that limit corporate, bank and financial disclosures, financial*

*professionals often use offshore tax haven jurisdictions as a ‘black box’ to hide assets and transactions from the Inland Revenue Service, other U.S. regulators and law enforcement.*<sup>306</sup>

The findings of this report led Senator Carl Levin, senior ranking Democrat in the Senate, to conclude that: *“tax havens have in effect declared war on honest taxpayers.”* Tax havens are, of course, only a more visible manifestation of the organised tax avoidance industry which functions on behalf of wealthy individuals and corporate clients in a manner explicitly intended to confront the will of elected legislatures around the world. Tax avoidance is justified by some on the basis that it is legal, though one widely used definition describes it as a course of action designed to conflict with or defeat the evident will of Parliament.<sup>307</sup> The scale of this assault on parliamentary will is massive, involving not thousands but hundreds of thousands of highly educated legal and financial specialists operating in jurisdictions across the globe.

As illustration of the subversive nature of the organised tax avoidance industry, another recent US Senate enquiry revealed internal communications from accounting multinational KPMG which contained a warning from one senior tax adviser that, were the company to comply with the legal requirements of the Inland Revenue Service relating to the registration of tax shelters, the company would place itself at a competitive disadvantage and would:

*not be able to compete in the tax advantaged products market.*

<sup>304</sup> P.J. Henahan, senior tax partner of Ernst & Young, in an article published in the *Irish Times* on 7<sup>th</sup> May 2004

<sup>305</sup> Kennedy-Glans, D. and Schulz, B (2005) *Corporate Integrity: A toolkit for managing beyond compliance*, John Wiley & Sons, Ontario

<sup>306</sup> US Senate Permanent Subcommittee on Investigations (2006) *Tax Haven Abuses: The Enablers, the Tools, the Secrecy*, August, p2

<sup>307</sup> Lord Nolan per *IRC v Willoughby* (1997)

Undeterred, KPMG went ahead with:

*knowingly, purposefully and wilfully violating the federal tax shelter law.*<sup>308</sup>

During its enquiries the Senate Committee discovered that KPMG had devised over 500 'active tax products', some of which may have been illegal. Just four of those 500 products cost the US Treasury US\$85 billion annually in lost tax revenues, whilst KPMG booked US\$180 million in fees. Speaking after the conclusion of the Senate Committee's enquiries, senior ranking Democrat Senator Carl Levin said that: *"our investigations revealed a culture of deception inside KPMG's tax practice."*

The USA is ahead of the game in investigating and condemning the activities of the organised tax avoidance industry. Significantly, the Senate report mentioned above was produced by a Subcommittee chaired by a prominent Republican and supported by a prominent Democrat. Nothing similar has been produced by either the European Commission or Parliament. The Commission's attempt at combating tax evasion through the Savings Tax Directive, which came into force in July 2005, was rendered virtually impotent by extensive lobbying and political shenanigans. Both the World Bank and the International Monetary Fund have developed their own anti-corruption agendas, but neither institution has sought to tackle offshore banking secrecy other than where it has impacted on their rigidly restricted anti-money laundering programmes. The Financial Action Task Force formed by G-7 heads

of state in 1989 to spearhead global anti-money laundering programmes, has resolutely turned a blind eye to capital flight and tax evasion, and has arguably legitimised the tax havens which cooperated with its efforts to track the proceeds of narco-trafficking and terrorist funding.

In addition to corrupting financial systems by encouraging and facilitating illicit activities, offshore secrecy corrupts the market system more generally by enabling company directors to engage in aggressive tax planning to raise short term profitability (thereby enhancing share option values), and gain a significant advantage over their nationally based competitors. In practice, this bias favours the large business over the small, the long established over the start-up, and the globalised business over the local.<sup>309</sup> In other words, corporate tax avoidance works against the operations of fair trade, fair competition and ethical enterprise, but until now tax justice has scarcely registered on the Corporate Social Responsibility debate.<sup>310</sup> Indeed, a recent business symposium hosted by transnational accounting firm KPMG concluded that: *"tax avoidance does not damage corporate reputations and may even enhance them".*<sup>311</sup> So much for corporate social responsibility!

## The corruption interface

<sup>309</sup> See 'tax us if you can - the true story of a global failure', TJN, 2005

<sup>310</sup> See for example Christensen, J. & Murphy, R. (2004) *The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the bottom line*, *Development*, volume 47, number 3, (37-44)

<sup>311</sup> <http://www.taxresearch.org.uk/Blog/category/kpmg/> accessed 28 August 2006

<sup>308</sup> US Senate Permanent Committee on Investigations (2003) *The Tax Shelter Industry: the role of accountants, lawyers and financial professionals*, Washington DC, US Senate, p13



There is clearly an urgent need for reassessment of what constitutes corruption; how it is perpetrated; and by whom. It is impossible to disagree with those who, whilst deploring domestic corruption involving bribe-taking and kickbacks on contracts, are puzzled by the way in which the corruption debate has focused on the bribe-taking by public officials whilst largely ignoring the role of private companies in offering bribes and kickbacks, and the equally important role of the pinstripe infrastructure which encourages, facilitates and profits from handling the proceeds of criminal activity, including tax evasion. As one expert witness described it to a recent UK Parliamentary enquiry into the role of the UK in corrupt activities in Africa:

*With one hand, the West has pointed the finger at corrupt African leaders, with its other hand, its bankers, lawyers, accountants, art dealers, health authorities, universities, estate agents and embassies have been actively or passively encouraging wealth out of Africa into the West's economies.*<sup>312</sup>

In terms of scale, the proceeds from bribery, drugs money laundering, trafficking in humans, counterfeit goods and currency, smuggling, racketeering, and illegal arms trading account in aggregate for around 35 per cent of cross-border dirty money flows originating from developing and transitional economies. On the other hand, the proceeds from illicit commercial activity, incorporating mispricing, abusive transfer pricing and fake and fraudulent transactions account

for 65 per cent of such flows.<sup>313</sup> The very least one might expect in such circumstances, is that equal emphasis be given to corruption in both private and public spheres; that greater prominence be given to how corruption can reduce tax revenues by as much as 50 per cent;<sup>314</sup> and that the activities of the offshore system should be more carefully scrutinised to ascertain the harmful impacts of tax havens on the functioning of global markets and on the integrity of the rule of law. As Raymond Baker notes:

*"Illicit, disguised and hidden financial flows create a high-risk environment for capitalists and a low-risk environment for criminals and thugs. When we pervert the proper functioning of our chosen system, we lose the soft power it has to project values across the globe. Capitalism itself then runs a reputational risk. As it is now, many millions of people in developing and transitional economies scoff at free markets, regarding the concept as a license to steal in the same way as they see other others illicitly enriching themselves."*<sup>315</sup>

The secrecy space offered by the offshore interface, which currently comprises approximately 70 tax havens spread across the globe,<sup>316</sup> represents a glaring flaw in the global financial architecture. This flaw is routinely exploited by financial intermediaries for

<sup>312</sup> Dr Patrick Darling in written evidence to the UK Africa All Party Parliamentary Group, quoted in *The Other Side of the Coin: The UK and Corruption in Africa*, AAPP, March 2006

<sup>313</sup> Baker, R., (2005) *Capitalism's Achilles Heel*, John Wiley & Sons, Hoboken, New Jersey, p369

<sup>314</sup> *The Other Side of the Coin: The UK and Corruption in Africa*, report by the Africa All Party Parliamentary Group, March 2006, p12

<sup>315</sup> Baker, R., (2005) *Capitalism's Achilles Heel*

<sup>316</sup> TJN's map of tax havens is at: <http://www.taxjustice.net/cms/upload/pdf/mapamundi.pdf>



the simple reason that this is the most profitable fee-earning activity. It is long overdue that the role of the facilitators, and of their professional associations which fail to effectively regulate their activities, is recognised as harmful and corrupt and consequently given parity of attention to that paid to the bribe-taking of less well paid officials in the world's poorer countries.

Support for a shift in the corruption debate to include the role of the supply side agencies is evident in the 2006 statement of the Pontifical Council for Justice and Peace, which noted that:

*"A ready climate for corruption is fostered by a lack of transparency in international finances, **by the existence of financial havens** and by the disparity between the level at which corruption is fought - often limited to the level of single states - and the level at which corruption is carried out, usually at the supranational and international levels."*<sup>317</sup>

Despite evidence that public attitudes towards corruption are hardening throughout the world, further convergence is required before a truly international definition of corruption can be arrived at. In the interim it would be preferable to identify the entire range of activities which involve the abuse of power and privilege for personal gain, and not focus principally on those involving the bribery of public officials in developing countries. Comparatively speaking the losses to most of the world's poorer countries from illicit capital flight and tax evasion are likely to considerably exceed the financial cost of bribery, and consequently greater weight needs to be given to identifying

the scale of the problem and to tackling the failures of the financial architecture which allow the perpetuation of these practices. It is in this context that the TJN calls for a wider debate about what constitutes corruption, and whether and how it can be defined and measured to include the activities of the supply side agencies and the offshore interface. TI could and should play a lead part in this process by rethinking the definition employed in the CPI's construction to take in a wide range of activities which undermine public confidence in the integrity of the governance of public and private sector institutions. The conclusion of this debate might lead to a less generalised approach, with specific activities (bribery, embezzlement, tax fraud, market-rigging, insider-trading, etc) being treated as distinct forms of corruption. If TI wishes to retain the national comparator approach of the CPI it should extend the range of indicators used to identify corrupt practices to include factors which facilitate corrupt practices such as non-disclosure of corporate beneficial ownership; the use of nominee directors and shareholders; banking secrecy laws; the lack of transparency of ownership and beneficiaries of trusts and similar legal entities; and non-cooperation with bilateral information exchange between national authorities. Other institutional factors such as the framework of international accounting standards which enable multinational corporations to adopt elaborate aggressive tax avoidance strategies and to use opaque accounting systems and trade mispricing practices should also be taken into account, particularly since this is an area of corporate governance where the rules are set by a private sector agency which is not accountable to democratic scrutiny or control.

Throughout the developing world, tax evasion and the looting of resources to

<sup>317</sup> Cardinal Renato Martino, (2006) *The Fight Against Corruption*, Vatican City, October

secret bank accounts has nurtured resentment, caused unemployment, reduced investment in infrastructure and public services, and shifted the tax burden increasingly onto middle income earners and poor people. But this need not be the case. Most of these problems could be remedied by strengthening international cooperation. Effective information exchange between national authorities would go a long way towards overcoming the problems of capital flight and tax evasion. The barriers posed by banking secrecy could be overcome by over-ride clauses built into international treaties. The secrecy of offshore trusts would be reduced by requiring registration of key details relating to the identity of the settlor and beneficiaries. There is no reason why those who benefit from the privileges conferred by using companies and trusts should not accept the obligation of providing basic information about their identity. Global frameworks could be agreed for taxing multinationals on the basis of where they actually generate their profits. Policies such as these could be implemented in a relatively short time frame. The principal barrier standing in the way of progress towards achieving these goals is the lack of political will on the parts of the leaders of the OECD nations, most notably Switzerland, the USA and the UK, all of which are leading tax haven states. This lack of political will stems largely from the fact that western leaders, who point fingers at corrupt politicians and public servants in poorer countries whilst conveniently ignoring the harmful role of

the offshore interface, are all too aware of the extent to which their own economies have become geared to dependence on capital flows from the poorer countries. They get away with this because public perceptions in the west have been shaped to pay no attention to the offshore interface. The CPI has done nothing to change this situation.

If western leaders are genuine about their commitment to helping African nations to effectively tackle corrupt practices, they should begin by addressing the structural flaws in the global financial architecture which enable the exploitation of fiscal loopholes and offshore tax havens. They need also to recognise that the culture of corruption which causes so much harm in Africa is a reflection of a similar culture in the industrialised countries, where privileged business and political elites regularly abuse their status for personal gain. It needs also to be recognised that the reality of Europe and North America's commitment to 'globalisation' is that they want liberalised trade on their own terms but continue to use fiscal incentives to distort the trade system in favour of their domestic businesses and to attract capital from developing and emerging countries. Britain stands pre-eminent in this respect, and should take a lead in helping African nations by tackling its own, deeply embedded culture of corruption.

## Appendix 5

# Jersey passes law allowing 'sham' trusts for use by tax evaders

(Article from the blog of Tax Research LLP, written by Richard Murphy and published 15 June 2006 at <http://www.taxresearch.org.uk/Blog/2006/06/15/jersey-passes-law-allowing-'sham'-trusts-for-use-by-tax-evaders/>)

I have always had a considerable problem with the concept of trusts, even as a practicing tax accountant. But I have much more of a problem with Jersey's new trust laws passed in May 2006 which allow the creation of 'sham' trusts where there is in fact no such thing, but just the bogus impression of one. I have even more difficulty with this because I have no doubt that Jersey knew the new laws would facilitate tax evasion. Indeed, it is hard to see what other purpose they could have.

Let me deal with the concept first though. Trusts are an instrument normally only available in Anglo Saxon common law. Wikipedia<sup>318</sup> describes a trust as:

*"a relationship in which a person or entity (the trustee) holds legal title to certain property (the trust property) but is bound by a fiduciary duty to exercise that legal control for the benefit of one or more individuals or organizations (the beneficiary), who hold "beneficial" or "equitable" title"*

I have simplified this slightly for clarity, but that is a fair description. To put it another way, one person says to a second "please look after this asset for me, but

when doing so make sure (for example) that the income goes to this third person during their life and when they die the remaining property goes to another, fourth person". All trusts are meant to incorporate this split of roles, responsibilities and entitlements. If they did not then there would be no need for a trust. The property would be owned absolutely by one person for their own benefit.

Why is this important? There are two reasons. First of all trusts are not registered. Unlike companies or partnerships which are either legal entities, or which if trade have to disclose their identity, if not their accounts, there is no requirement anywhere that I know of for a trust to be registered even though it is an artificial arrangement that exists only under the rule of statute law, even if the concept started in common law. So trusts are used to assist secrecy on and offshore, and especially in the latter case where nominee trustees act as trustees to hold nominee shares in companies managed by nominee directors etc., etc. As the Swiss rightly point out this means that the UK and its offshore dependencies do not need banking secrecy to achieve the benefit for clients they had to introduce banking secrecy for, Anglo Saxon common law countries achieve it through trusts. This secrecy is almost without exception harmful.

<sup>318</sup> [http://en.wikipedia.org/wiki/Trust\\_law](http://en.wikipedia.org/wiki/Trust_law)  
accessed 22-1-07

Second, and as importantly, the role of trusts in tax planning is dubious at best. Unfortunately the UK has encouraged this. For example when the EU Savings Tax Directive was introduced the entities for whom disclosure of information would have to be made did, in the opinion of the EC, include trusts. But the UK objected, saying trusts were not entities and so helped massively reduce the effectiveness of the Directive. It was not one of the UK's prouder moments.

Now I come to my main point. Because the use of a trust can prevent disclosure of offshore interest earned under the terms of the EU Savings Tax Directive to a person's home country of residence those seeking to avoid such disclosure have poured their cash into them. My recent research on funds held in Jersey proves this point. And, as a matter of fact the trust market in Jersey has boomed, up by 30 per cent, for example, in 2004 according to Phil Austin, CEO of Jersey Finance. The reason is simple. There are a great many people who have money on which tax has been evaded in Jersey and elsewhere and who do not want the interest declared to their home state as that would lead to questioning on where the money on which the interest was paid came from as well as to questions about the interest itself. Using a trust prevents such questions arising and perpetuates the tax evasion.

But note what a trust is. It is something where the settlor gives the property away. This imposes a cost on the settlor. But now look at what Jersey's doing with its new trust law. These are explained by the Jersey firm of Volaw Trust & Corporate Services Limited<sup>319</sup>. Jersey will now allow the creation of what can only be called 'sham trusts', although they're

calling them trusts with 'reserved powers for the settlor'. What are those reserved powers? Well, the settlor can tell the trustee what to do, which means the trustee only has a nominee role. And the settlor can claim the property back, which means that no gift of assets into trust has taken place since they clearly remain in the ownership of the settlor in that case. And, because they can be claimed back the settlor is always likely to be the beneficiary of such a trust. In other words, the settlor continues to have complete beneficial ownership of the asset and there is in fact no trust in existence at all, just a sham that suggests that there is.

In that case what is Jersey actually doing by passing this law? It is creating a situation where a person can claim they have put an asset into trust but the reality is they have done no such thing. This is a completely bogus transaction. And why would Jersey want to do this now? I have no doubt that a primary reason is to assist people who wish to avoid declaring their income under the EU Savings Tax Directive or suffer tax withholding at source, which is the alternative. Indeed, at a meeting I attended recently some very senior people in the financial services industry complained about the effort they have had to put into the process of creating such arrangements to assist those clients who had evaded funds offshore and who do not wish them to be disclosed now even though (as I suggested to them) they are assisting money laundering by doing so. These new trusts assist that objective and shoot a massive hole through Jersey's claim to only want legitimate business in the Island.

There is only one purpose for this new law. It is to promote secrecy, and the prime use for that is to assist tax evasion.

This legislation proves that the mentality of promoting aggressive tax avoidance and

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<sup>319</sup> <http://www.volaw.com/pg605.htm>  
accessed 22-1-07



even of providing shelter for outright tax evasion persists in Jersey, and is, regrettably, assisted by its government, which passes legislation of this type that facilitates such arrangements.

## About the authors

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## About the Tax Justice Network

The Tax Justice Network brings together organisations, social movements and individuals working for international tax co-operation and against tax evasion and tax competition. In an era of globalisation, the TJN is committed to a socially just, democratic and progressive system of taxation. TJN campaigns from an internationalist perspective for a tax system which is favourable for poor people in developing and developed countries, and finances public goods and taxes public bads such as pollution and unacceptable inequality. TJN's objectives are detailed in the TJN declaration ([www.taxjustice.net](http://www.taxjustice.net)).

TJN is a pluralistic, diversified, non-governmental, non-party and multilingual network. Local, regional and national civil society and social movement organisations as well as tax justice campaigners, researchers, journalists, development specialists, trade unionists, concerned business people, tax professionals, politicians and public servants are members and supporters of the network.

TJN is campaigning for social change through public debate and education. Public understanding of tax matters is the

precondition for international tax justice. The network makes information available through mass media as well as through conferences and seminars, the internet, newsletters, publications in print, symbolic actions, demonstrations and advocacy. We base our activities on expertise and sound research.

TJN facilitates co-operation, communication and information sharing between its members. The network organises international exchange and policy debates in order to harmonise the views and concerns of our members. This process forms the basis for powerful global campaigns in international tax policy.

TJN is run by its member organisations as well as individual supporters. The network functions on the principles of participatory democracy, empowerment, transparency, accountability and equal opportunity. TJN encourages and where necessary supports member organisations and individuals to participate in the decision making. The network supports the building of national TJN campaigns in particular in developing countries. An international secretariat coordinates the network's activities.