Illicit Financial Flows:

Overview of Concepts, Methodologies and Regional Perspectives

Report of a Mentoring Workshop on Illicit Financial Flows
organized by Centre for Budget and Governance
Accountability and Financial Transparency Coalition

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Credits

This report – 'Illicit Financial Flows: Overview of Existing Research Methodologies and Approaches' – is based on a Mentoring Workshop organised by Centre for Budget and Governance Accountability and Financial Transparency Coalition, in New Delhi in December 2014.

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The chapters of the report are based on the capacity building sessions facilitated by the following experts:

Chapter one, 'Concepts, Typology and the Data on IFFs' is based on the session facilitated by *Alex Cobham,* presently with Tax Justice Network.

Chapter two, 'Different Methods of Estimation of Trade-based IFFs' is based on the session facilitated by *Simon Pak,* Associate Professor of Finance, Pennsylvania State University.

Chapter three, 'A Discussion on Financial Secrecy Index (FSI) and How to Use It' is based on the session facilitated by *Andres Knobel,* Tax Justice Network.

Chapter four, 'Exposing Corporate Tax Practices: How to Structure Research and Build a Company Case Study' is based on the session facilitated by *Martin Brehm Christensen,* Action Aid.

Chapter five, 'International Standards for Exchange of Information between Jurisdictions' is based on the session facilitated by *Andres Knobel,* Tax Justice Network.

Chapter six, 'Regional Perspectives' has three subsections:

- EU Perspectives' is based on the presentation given by *Koen Roovers,* Financial Transparency Coalition.
- Base Erosion and Profit Shifting in India' is based on the presentation given by *D. P. Sengupta,* Former Jt. Sec. of the Tax Department, Ministry of Finance, Government of India, and Consultant, National Institute of Public Finance and Policy.
- Transfer Mispricing with a Special Focus on Argentina' is based on the presentation given by *Veronica Grondona,* CEFID-AR Argentina.

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CONTENTS

Introduction

This report has been compiled on the basis of a mentoring workshop organised by Centre for Budget and Governance Accountability (CBGA) and Financial Transparency Coalition (FTC) in New Delhi in December 2014. The workshop brought together some experts and academics in the field of IFFs and the FTC Asia network members, to facilitate capacity building of Asian CSOs to generate evidence on IFFs.

The purpose of the report is to discuss some of the important concepts and issues related to illicit financial flows (IFFs) and to present a few existing research methodologies on these issues, which could enable CSOs, journalists and policy researchers generate relevant evidence on IFFs. The report is organized into the following sections:

Chapter One has been devoted to the types of IFFs and the concepts associated with them. It then goes on to present the different methodologies used to measure IFFs.

Chapter Two provides additional details on measuring IFFs generated through trade mispricing with some guidelines on how this could be curtailed.

Chapter Three discusses the Financial Secrecy Index (FSI),an index built by Tax Justice Network, and discusses how this could be used in research and advocacy.

Chapter Four presents a detailed description on how an organization or individual could build a case study on a company's financial status.

Chapter Five discusses the different forms of exchange of tax information between jurisdictions. The chapter explores the existing cooperation between jurisdictions in terms of information exchange.

Chapter Six provides regional perspectives on these issues. It highlights recent developments in the European Union, implementation of the Base Erosion and Profit Shifting (BEPS) initiative from the perspective of India and some insights on transfer mispricing from Argentina.

Chapter 1

Concepts, Typology and the Data on IFFs

Based on the session facilitated by **Alex Cobham,** presently with Tax Justice Network, titled 'Demystifying Illicit Financial Flows: Methodologies, Data and Opportunities'.

Concepts, Typology and the Data on IFFs[1]

Definition and Typology:

There are two main definitions of illicit financial flows (IFF). One equates 'illicit' with 'illegal', so that IFF are movements of money or capital from one country to another that are illegally earned, transferred, and/or utilized. This would include individual and corporate tax evasion but not avoidance (which is legal), and other criminal activity like bribery or the trafficking of drugs or people.[2] The other (e.g. Cobham, 2014) relies on the dictionary definition of 'illicit' as 'forbidden by law, rules or custom' – encompassing the illegal but also including the socially unpalatable, such as the multinational corporate tax avoidance that is the target of the OECD BEPS (Base Erosion and Profit Shifting) initiative.

In practice, the narrower definition has been more commonly seen; but the wider one is in fact more commonly used in practice. Jim Yong Kim, the head of the World Bank – an institution which has historically been highly conservative in this regard – recently expressed this view: "Some companies use elaborate strategies to not pay taxes in countries in which they work, a form of corruption that hurts the poor."[3]

On the basis of a preferred definition, IFFs can be listed according to either aim or channel. The original list, given in Raymond Baker's 'Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System' in 2005 and subsequently reformulated by Global Financial Integrity (GFI), focuses on the **aim** and encompasses commercial tax evasion, the laundering of criminal proceeds, and the bribery of public officials and/or theft of state assets.

A somewhat broader categorisation identifies four major types of IFF:

1) **Market/regulatory abuse:** IFFs are generated by trying to bypass the operating regulations that are in place to keep a market in check, for instance, to prevent one player from monopolising a market; or to prevent politicians and officials hiding conflicts of interest. Most obviously, such IFFs give rise to the use of anonymous shell companies in secrecy jurisdictions for inward investment (often round-tripping).

2) **Tax abuse:** Tax abuse may take place through commercial tax evasion and BEPS activity, transfer mispricing etc.; and through the hiding of individuals'

[1] This chapter is based on a session facilitated by Alex Cobham, presently with Tax Justice Network, named "Demystifying Illicit Financial Flows: Methodologies, Data and Opportunities".

[2] https://financialtransparency.org/whats-an-illicit-financial-flow/

[3] http://www.france24.com/en/20151001-corporate-tax-dodging-corruption-world-bank-chief

assets and income streams in secrecy jurisdictions which either do not record the beneficial owners, or do not share that information with the relevant tax authorities.

3) **Abuse of power:** IFFs are also generated by way of allocation of state resources to favoured parties without a transparent process in place – including for example bribes to secure mining concessions or public contracts or tax incentives, or favourable treatment for an industry such as tobacco. Although such IFFs typically emerge from the private sector, the impact is largely public and is felt through weaker governance and reduced government resources.

4) **Proceeds from crime:** Where initial capital is legal, all options are open; but the proceeds from crime can only be transferred from one jurisdiction to another by illicit routes. These funds are often routed to and through low tax jurisdictions or strong secrecy regimes, hiding the criminal origin. The 'Hawala' system, prevalent most in South Asia and the MENA region is often said to be one of the most popular routes of illegal transfer of assets; although hard data to make comparable estimates is largely lacking.

Estimation:

Most methods of estimating IFFs are based on the identification of anomalies in relevant data series, which are then used to estimate IFFs in a particular broad channel. It is interesting to note here that since the various types of IFF by aim can each use multiple channels and since each channel can facilitate multiple types of IFF, these estimates do not allow for comparative assessments of the scale of IFF types.

Estimation of trade-based IFFs can be done using three types of data:

1) **Transaction-level data:** Transaction-level data represents the gold standard for the analysis of trade-based IFFs. **Simon Pak** and **John Zdanowicz** pioneered work (partially published in 2003) for the US Congress to estimate the extent of abnormal trade-pricing, including the potential tax revenue impact, and also set in motion a number of major criminal investigations. A detailed discussion on the method of the estimation is provided in a subsequent section.

   An important drawback is that the data available from (or to) one country's authorities is typically one-sided: that is, only transactions in or out of the particular country are included, rather than also having data on the same transactions as recorded in the partner country. With two-sided transaction-level data, fraudulent declarations (e.g. of different prices for the same transaction) can also be identified. Even with cooperation between customs authorities, there remain substantial technical challenges to ensure the data can be used.

2) **Commodity-level aggregate data**: The biggest advantage that commodity-level aggregate data has over transaction-based data is that the former is generally available on a two-sided basis. Most countries report their commodity-trade data to the **UN Comtrade** system, which is publicly accessible. While aggregated, this data is reasonably detailed (up to six digits in industry classification codes). The advantage of a six-digit level classification is that deliberate misclassification can be effectively tackled if the scope of classification is increased even slightly. For instance, it is possible to misclassify a copper cathode of a particular length as copper ash, but as soon as one broadens the

scope to consider copper as one commodity, the issue of misclassification is addressed. But such broadening makes it much less reasonable to compare average prices in search of abnormalities, since such different commodities are included; and so working with this partially aggregated data requires making a tradeoff between the different risks.

Recently, UN Comtrade began also to publish data on a monthly basis, which reduces the extent of aggregation (so that, for example, price volatility over the course of a year in commodities such as oil can be addressed to an extent). However, there is again a tradeoff since using monthly data exacerbates the risk that transactions are recorded in a different time period at each end (exports recorded in month 1, corresponding imports in month 2).

Finally, Comtrade does not differentiate (as transaction-level data should allow) between related party trades, i.e. those between different subsidiaries of the same multinational enterprise, and all others. As such, it cannot distinguish trade mispricing from transfer mispricing.

3) **National-level aggregate data:** The most aggregated data is the IMF Direction of Trades (DOTS) data set. The one advantage of DOTS is that some adjustments are made to allow for 'merchanting' hubs such as Hong Kong, when they form part of a trading chain on paper only. However, such adjustments are badly documented and do not appear to be consistent across jurisdictions; while the high level of aggregation eliminates all possibility to consider the commodity source of any observed mispricing and so investigate further. As such, DOTS-based estimates should be treated with additional caution.

Estimation of **finance-based IFFs** involves three categories of data:

1) **Capital account estimates:** This method of estimating IFFs is commonly used, notably by GFI and Ndikumana and Boyce. The two most commonly used method sare the *World Bank Residual Method (WBR)* and the *Hot Money 'Narrow' Method (HMN)*. Both these methods rely on anomalies in the Balance of Payment (BoP) identity, with the WBR method likely to exhibit a substantial upward bias so that the HMN method (which simply equates to 'errors and omissions', the balancing residual) is generally used.

   Some individual country studies have taken alternative approaches - for example, in Afghanistan, an estimate was based on measures of bulk cash ($100 bills) transactions. While such approaches will typically result in smaller IFF estimates than the BoP approach, there may be a higher degree of certainty. In general, there is probably more scope currently to generate better country-level methodologies than there is to extend global analyses using BoP data.

2) **Individual 'offshore' wealth estimates:** There are three different ways of measuring offshore wealth as has been concluded by **James Henry** (2012). These are:

   i) Accumulated 'offshore' wealth: A possible way to measure accumulated offshore wealth is to use the data generated by the BoP approach, in order to deduce how much wealth is illicitly removed to 'offshore' destinations. Ndikumana and Boyce used this method for Africa to estimate accumulated offshore wealth of $1.08 trillion in 2010. Since Africa contributed about

3.5% of the world's GDP that year, we could scale the figure up to approximately $28-30 trillion globally.

ii) **Private banking assets:** Another way of measuring offshore wealth is to analyse data on private banking assets to find private cross-border wealth under management. In 2010, the top 50 banks of the world gave a figure of $12 trillion of such assets.

iii) **Offshore investor portfolio model:** Data on the cross-border deposits, which can be procured from Bureau of Industrial Security (BIS), could be used to calculate the proportion of investors' portfolio that is held in cross-border deposits.

James Henry in 2012 estimated offshore wealth to be between $21 trillion to $32 trillion through four approaches:

- Sources and Uses' model for country-by-country unrecorded capital flows
- Accumulated Offshore Wealth' model
- Offshore Investor Portfolio' model
- Private banking assets in the top fifty global banks.

There are other ways of measuring the amount of offshore wealth. Gabriel Zucman used the difference between reported assets and liabilities of jurisdictions to estimate the scale of assets which are not reported for tax or other purposes. This **liability-asset mismatch method** yields a low-end estimate of around $8 trillion, and an estimated annual tax loss on the resulting (undeclared) income streams of $190 billion globally.

3) **Base erosion and profit shifting:** Estimates reflect the location of multinationals' activity, investment and anomalous patterns of declared income (and will also include trade-based IFF). As the OECD staff found in attempting to deliver BEPS Action 11, the current paucity of available data makes it impossible to construct a baseline for the global scale of BEPS. However, a number of estimates have been constructed.

   a. For their World Investment Report 2015, UNCTAD staff assessed the extent of anomalies in reported (taxable) income when foreign direct investment was channeled into developing countries via jurisdictions they identified as tax havens and special purpose entity (SPE) locations. A developing country revenue loss of around $100 billion annually via this channel of BEPS was estimated.

   b. IMF researchers Crivelli et al. (2015) consider the impact of 'spillovers' from tax haven jurisdictions and others on to the tax revenues of OECD and developing countries, finding total developing country revenue losses of around $200 billion annually, and $500 billion for OECD countries.

   c. Cobham & Janský (2015) use data on US multinationals to confirm Gabriel Zucman's (2014) finding that a handful of jurisdictions with little real economic activity account for a disproportionate share of profits. Cobham & Janský estimate total profit-shifting for 2012 (the most recent year for which data are available) in excess of $600 billion (25-30% of total profits), with revenue losses potentially of $160 billion. The limitation of this kind of data is that it only involves MNCs in the USA - but the advantage is that this data reveals the global activity of these MNCs, whereas even the leading balance sheet database is unsuitable for examining developing country impacts (Cobham & Loretz, 2014).

An alternative to anomaly-based estimation of IFFs which may yield additional insights is to focus on risk instead, and specifically to examine the relative vulnerability of countries to financial secrecy. This approach, pioneered in the work of the African Union/Economic Commission for Africa's High Level Panel on Illicit Flows out of Africa (2015), rests on the view that since IFF are by definition hidden – whether legal or not – the extent of secrecy of economic and financial partner jurisdictions can be used to construct measure of risk that IFF are being hidden. To put it more simply, trading with Switzerland, or accepting investment from the British Virgin Islands, exposes a country to a greater risk of IFFs than trading with Denmark or accepting investment from France.

The High Level Panel shows how the Tax Justice Network's **Financial Secrecy Index (FSI,** the major ranking of tax haven jurisdictions), can be combined with data on bilateral trade, investment and banking to construct measures of relative vulnerability to IFF risk. A detailed discussion on this index is provided in a subsequent section.

Chapter 2

Different Methods of Estimation of Trade-based IFFs

Based on the session facilitated by **Prof. Simon Pak,** Associate Professor of Finance, Pennsylvania State University, titled 'Trade Mispricing: Estimation Methods and An Approach to Curtail'.

Different Methods of Estimation of Trade-based IFFs[4]

Transfer pricing: The business world is governed primarily by the objective of profit maximization. Minimising an entity's tax liability is one of the methods for increasing profits. Transfer pricing provides corporations with the opportunity to manipulate their tax obligations in order to maximize their after-tax income. Although a subset of trade mispricing, this mechanism is an important source of generating IFFs. This chapter is devoted to different methods of estimating trade mispricing. A subsequent section of this report also analyses the issue of transfer mispricing, with a focus on Argentina and how the country's legal system has evolved over the years to tackle the problem.

Pak *et al.* (2014) observed that trade mispricing is often practiced with a motive to either shift incomes from countries with a higher tax rates to low tax jurisdictions, or to shift capital out of an exporting country thereby reducing the taxable income there. Trade mispricing also facilitates tax avoidance, import duty and VAT avoidance, and money laundering.

Methodology:[5]

The best way to measure the magnitude of trade mispricing is to calculate the deviation of the declared per unit value of the transaction from the arm's length value. However, a straightforward estimation of mispricing is often challenging because import and export trade data at transaction level is not available publicly, and arm's length price relevant to each merchandise transaction is not readily available for most of the commodity classifications (Pak 2012).[6]

In view of this problem, several methods of estimation have been proposed as second best alternatives. Two of the most widely employed methods of estimation of trade mispricing by international bodies, policy makers, and academics are **country-partner trade analysis method** introduced by Bhagwati (1964, 1974) and the **price filter analysis method** introduced by Pak and Zdanowicz (1994).[7]

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[4] This chapter is based on a session facilitated by Prof. Simon Pak, Associate Professor of Finance, Pennsylvania State University, named "Trade Mispricing: Estimation Methods and An Approach to Curtail".

[5] The methodology has been borrowed from Pak et. al. (2014), "Measuring Abnormal Pricing - An Alternative Approach: The Case of US Banana Trade with Latin American and Caribbean Countries": Journal of Money Laundering Control, Vol. 17, pp: 203-218.

[6] Pak, S. (2012), "Lost Billions: Transfer Pricing in the Extractive Industries: Estimates of Mispricing in Crude Oil Import - The European Union and the United States, 2000-2010": Publish What You Pay Norway, January 2012 (ISBN 978-82-93212-04-1)

[7] Pak, S. & J. S. Zdanowicz. (1994), "A Statistical Analysis of the U.S. Merchandise Trade Data Base And Its Uses in Transfer Pricing Compliance and Enforcement": Tax Management: Transfer Pricing Report, Vol.3, No.1, May 1994

1. Country-Partner Analysis:

The methodology of country-partner analysis requires trade data from both the participants engaging in a transaction for the estimation of degree of trade mispricing. It defines the degree of trade mispricing as the difference between the total declared amount of exports from one country to a partner country and the total declared amount of the corresponding imports in the partner country. The difference between the partners' declared value of imports from the country and country's declared total value of exports to its partner may be treated as the aggregated amount from all undervalued exports. That is:

Undervalued export amount = Partner's declared import value - Country's declared export value

Overvalued import amount = Country's declared import value - Partner's declared export value

The underlying critical assumption of this approach however, is that the declared value in the partner country – which the model assumes to be an advanced economy – is a fair market value and hence has declared an arm's length value (ALV). This in turn is based on a further assumption that the database(s) of advanced economies are relatively more accurate.

2. Price Filter Method:

The absence of an ideal arm's length price to act as a reference price for the calculation of the degree of mispricing has led to the development of alternative approaches which could be employed as proxies for arm's length value. The objective here has been not to accurately estimate the amount of mispricing, but to flag the possible mispricing by highlighting cases that have a higher probability of involving suspicious transactions, involving money laundering, tax avoidance etc. The price filter analysis method attempts to evaluate each transaction against an arm's length price range and to estimate its deviation from this range. The first step in creating an arm's length price range involves creating a price filter matrix. The price filter matrix can be created in two ways – by using the publicly available free market values of commodities/commodity classification (from reliable sources such as UNCTAD or IMF) or by statistical methods (first introduced by Pak and Zdanowicz (1994)).

- **Price Filter Method using the free market price data (from UNCTAD):**

  Hong and Pak (2014) used the price filter approach to examine the degree of abnormal pricing in international trade, specifically in the case of import of bananas from Central America and Ecuador. In November 2009, the United States imported 9,847 tons of bananas from Costa Rica for $2.3 Million (CIF), thus paying $0.24 per kilogram. However, the free market importer's price recorded by the UNCTAD for the same month was $0.83 per kg or $8.2 million for 9,847 tons. This difference in pricing meant that the US importer's undervalued amount stood at $6 million, indicating a wealth inflow to the United States; although the authors could not evaluate whether it also meant $6 million less taxable income for Costa Rican exports as well, for that would depend on the actual amounts revealed by the exporters to the Costa Rican customs authority – a case which the authors did not consider.

- Price Filter using statistical method:

  In the absence of an ideal arm's length value, an alternative statistical approach has been suggested. This statistical approach, developed first by Pak and Zdanowicz (1994), makes use of an estimated upper quartile and lower quartile prices for every commodity category, for each country-partner pair as well as country-world pair to generate an arm's length price range. The declared price of each transaction is then evaluated against this range. If the declared price of a particular transaction falls within the inter-quartile price range, it is assumed to be an arm's length transaction.

Under this approach, the overpriced amount is assumed to be the deviation of the declared unit value (price) of a transaction from its upper-quartile price; that is, when the declared price exceeds the maximum value of the arm's length price range. Similarly the under-priced amount is assumed to be the deviation of the declared unit value of transaction from the lower-quartile price; that is, when the declared unit price is less than the minimum value of the arm's length price range.

The free market price filter (monthly) for the period 2000-2009 was created using a 10 per cent margin, both above and below the UNCTAD importer's price (FOB US ports). Calculated in this manner, the majority of declared banana import prices (CIF basis) are found to be lower than the UNCTAD's free market price. The banana import record shows a significant undervaluation from the price filter of 10 per cent below the market price.

This method, although helpful, is nevertheless a crude one. The transactions with prices outside the benchmark are valuable not because it determines the exact amount of mispricing, but because items will have a higher probability of mispricing. It is crucial for the concerned authorities of the respective governments to use this as a signal and investigate further, in order to determine the actual degree of mispricing. Furthermore, most often the customs departments in most of the countries rely on random investigations or on their informants to track down the cases of abnormal pricing. This method would help these government departments to track these abnormal cases in a more economical and efficient manner.

Country-partner and Price-Filter Methodologies: A Comparison

Following from the discussion regarding the two methodologies of ascertaining the degree of trade mispricing, it is imperative to discuss their relative advantages and disadvantages.

Country Partner Method:

Advantages

- The advantage of this approach is that there is no need to search for arm's length price for each transaction, since the advanced country's price is assumed to reflect fair market value.

Disadvantages

- The advanced country's data, which this method uses for estimation, if inaccurately declared (or mispriced) cannot be used to estimate the degree of mispricing. If a mispriced (under-priced or overpriced) transaction is declared in both countries identically, the CP analysis will not detect the mispriced amount.

- The other crucial limitation of CP method concerns net versus gross capital flows. If the trade data includes grouped records with multiple transactions, as in case of bilateral transactions, the result would be the net amount, instead of total gross amount. This happens because in case of grouped data or aggregated data some of transactions may be over or under-priced. As a result, it becomes difficult to identify suspicious transaction using the COMTRADE or DOTS databases.

Price Filter Method

Advantages

- The PF method provides a direct estimate of mispriced amount for each transaction without the requirement of the partner country's data.
- This method provides estimates for capital outflow and capital inflow by commodity.
- It enables a country to monitor and detect suspicious transactions in real time.

Disadvantages

- The price filter is created under the assumption that it is the arm's length price.
- Some of the observations may be due to clerical or recording errors.
- When the deviation is small enough to fall within the inter-quartile range, this method would not be able to detect it. Some traders may choose to make small deviations. Only if the volume of such a transaction is extremely large, would there be large costs attached to such mispricing.
- Volatile market price movement poses problems for this method. For example, crude oil prices tend to be highly volatile, even in a one-year period.

Detection of Abnormal Pricing: A Statistical Approach

In view of the problems of estimating trade data, alternative statistical methodologies have been suggested which can help governmental and international agencies determine the optimal level of audits and inspections of inbound and outbound cargos needed to detect abnormally priced imports and exports. These techniques require the analysis of historical price data for every commodity traded, the determination of a price that represents a measure of central tendency and the upper-bound and lower-bound prices representing benchmark prices in determining abnormality. The objective of using statistical audit inspection is to select international trade transactions which, if audited or inspected, would have a high probability of being abnormal. The audit and physical inspection of an international trade transaction would be conducted when the expected marginal benefit of the audit inspection exceeded the expected marginal cost. The upper-bound and lower-bound trigger prices could be adjusted over time to reflect historical marginal benefits and costs. Upper and lower bound prices could also be adjusted on an ad hoc basis by government officials based on other factors relating to the pricing of the commodity.

Chapter 3

A Discussion on Financial Secrecy Index (FSI) and How to Use It

Based on the session facilitated by **Andres Knobel,** Tax Justice Network.

A Discussion on Financial Secrecy Index (FSI) and How to Use It[8]

The Financial Secrecy Index (FSI)[9], published by the Tax Justice Network (TJN)[10], ranks jurisdictions according to their secrecy and the scale of their offshore financial activities. A politically neutral ranking, it is a tool for understanding global financial secrecy, tax havens or secrecy jurisdictions, and illicit financial flows or capital flight.

In addition to the ranking, the FSI contains narrative reports about many of the assessed jurisdictions, describing the history of their offshore centres and other relevant issues. Moreover, the FSI provides comprehensive detailed technical reports for every jurisdiction's legal framework,[11] offering data on more than 200 factors relating to financial secrecy. These reports serve as a verifiable source to justify the ranking of each jurisdiction.

Why is the FSI important?

While many countries and international organizations draw up tax havens lists, there is no consistency in the identification of global tax havens: each list identifies different jurisdictions as tax havens, and only very few appear at the same time in most lists. Why does this happen? First, most national tax haven lists identify jurisdictions which affect them specifically, but–understandably– they do not take a global approach. At the same time, international tax havens lists prepared by international organizations tend to be either discretional or directly subject to political pressure.

a) **The real issues**

Most tax haven lists focus on jurisdiction's null or low tax rates as the only relevant criteria. Slightly better are those based on OECD's standards on transparency for the exchange of information, although these tend to be very weak. Furthermore, when determining compliance with its standards, the OECD's Global Forum appears to be subject to political pressure too, as it was shown by a special "conditional" category created for Switzerland on the 2013 Global Forum rating. Opposed to this, the FSI prefers the term "secrecy jurisdiction" because it considers that the most relevant factor for tax evasion and other crimes is related to the opacity offered by jurisdictions. By providing secrecy, these jurisdictions aim to attract non-resident individuals and entities by allowing them to escape, evade or undermine laws, regulations or taxes from other countries. In other words, secrecy jurisdictions are used not only to pay less or no taxes, but also to remain hidden in order to launder proceeds of drug smuggling or corruption, market rigging, among many other crimes and abuses.

b) **Those actually – and mostly – responsible**

Most tax haven lists focus on small palmed-fringed islands, usually in the Caribbean or the Pacific as if they were the only source of the problem. For example, according to the Global Forum's ratings of October 2015, most jurisdictions were considered either 'largely compliant' or simply 'compliant' with international transparency standards, including the United States, even when the latter's peer review described that ownership information may not be available in the case of companies and trusts. Not

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[8] This chapter is based on a session facilitated by Andres Knobel, Tax Justice Network.
[9] http://www.financialsecrecyindex.com/
[10] http://taxjustice.net/
[11] http://www.financialsecrecyindex.com/introduction/fsi-2015-results

surprisingly, out of 34 jurisdictions which underwent an analysis of their legal framework (phase 1), the only eight which were considered not to be compliant enough to move on to phase 2 were Micronesia, Guatemala, Kazakhstan, Lebanon, Liberia, Nauru, Trinidad & Tobago, Vanuatu. Opposed to this, Switzerland was deemed ready to move on, although it still has banking secrecy under certain international agreements and no ownership registration for some types of companies. Likewise, out of 86 jurisdictions whose legal framework and application in practice was analysed (phase 2), there were no cases of non-compliance and the only 12 jurisdictions that were rated as partially compliant included Andorra, Anguilla, Antigua & Barbuda, Barbados, Costa Rica, Curacao, Indonesia, Israel, St. Lucia, Samoa, St. Maarten and Turkey. In other words, big OECD countries are systematically whitewashed.

In stark disagreement with this narrow approach, the FSI shows how major financial centres are the big enablers of global financial secrecy, and this includes many OECD countries. As it will be explained later in the FSI structure, the FSI combines a secrecy score which measures opacity provisions weighted by the market share of financial services for non-residents. This is because it understands that the bigger the financial center is, the more responsibility it has to be transparent. Otherwise, even relatively small transparency loopholes may still have huge global consequences. For example, the damage caused to the world by a small loophole in the US (which has almost a fifth of the world's market share of financial services for non-residents) is far greater than the damage of a big loophole in Vanuatu, which only has 0.001% of the market share.

c) **Objective criteria to monitor and push for effective measures**

Tax haven lists consist of binary blacklists (or white lists), suggesting that a jurisdiction either is a tax haven or it is not. In the latter case, it would appear that such jurisdiction poses no risk to transparency whatsoever. The FSI chooses a different approach. It does not attempt to determine a cutoff line to identify tax havens, but rather considers that all jurisdictions in the world lie somewhere within a spectrum between full opacity and full transparency, according to their degree of opacity in different fields (banking secrecy, corporate transparency, etc.). This way it is possible both to identify the real problems involving one jurisdiction and also to track its progress (or deterioration) in terms of transparency.

The FSI offers a 90-page methodology document available online, explaining its objective criteria. It also provides a source and date for every fact described or assessed. This unique feature differentiates it from most tax haven lists which are either discretionary or whose criteria remain unknown. This is what makes most tax haven lists subject to political pressure, as exemplified by the 2015 tax haven list drawn up by the European Union.[12] This "EU tax have list" included any jurisdiction that had been included in the national tax haven list of at least 10 EU countries. As a consequence of this, traditional tax havens such as Bermuda started lobbying national governments to convince them to be removed, so as to be below the 10-national-list threshold and thus disappear from the EU list. Bermuda was successful with Latvia[13] and Poland[14].

Panama was also successful when denouncing Argentina before the World Trade Organization. A panel ruled that Panama was right on many issues, and determined that Argentina's national tax haven list was arbitrary because its criteria to include or exclude countries were inconsistent and irrational.[15]

[12] http://www.eubusiness.com/news-eu/economy-politics.120n
[13] http://bernews.com/2015/06/bermuda-blacklisted-latvia/
[14] http://www.royalgazette.com/article/20150622/BUSINESS/150629930
[15] http://www.law360.com/articles/709936/wto-faults-argentina-over-rules-tied-to-tax-transparency

The structure of FSI

The FSI ranks jurisdictions according to their FSI value. This value is obtained after combining a jurisdiction's secrecy score (as a result of the transparency credit obtained in 15 Key Financial Secrecy Indicators, detailed below)weighted by the jurisdiction's market share of financial services for non-residents, called the Global Scale Weight. The latter is calculated based on the IMF working paper by Zoromé of 2007. The FSI focuses on 'non-residents', because it understands that no jurisdiction wants its own citizens to evade taxes or launder proceeds of crime or corruption. However, many jurisdictions seem to have little concern – or actually a big interest in attracting money from foreigners, regardless of its licit or illicit origin. Secrecy provisions in a jurisdiction's legal framework are what allow non-resident individuals and entities to evade, avoid or undermine rules, laws or taxes from abroad.

The Global Scale Weight is what allows the FSI to distant itself from most tax haven lists which pick up small countries as the only problem in global transparency. While it is true that a really opaque legal system has the potential to be extremely damaging, the consequence in practice is lessened when hardly anyone uses that jurisdiction to hide their money or identity. In contrast, major financial centres which attract deposits and incorporation of entities from all over the world may have dreadful consequences for illicit financial flows and the fight against most financial crimes, even if their secrecy provisions are not as terrible as that of other countries. This is worsened when no one even refers to financial centers' responsibility, and thus they stay the same while every other country needs to become more transparent. This turns into a vicious cycle where financial centres – like the United States – become even greater recipients of illicit financial flows which are escaping other jurisdictions (those which were forced to become more transparent).

The 15 KFSIs relate to: i) banking secrecy, ii) trusts and foundations' registration, iii) recorded company ownership, iv) public company ownership, v) public company records, vi) country-by-country reporting, vii) fitness for information exchange, viii) efficiency of tax administration, ix) avoids promoting tax evasion, x) harmful legal vehicles, xi) anti-money laundering, xii) automatic information exchange, xiii) bilateral treaties, xiv) international transparency commitments, xv) international judiciary cooperation. A detailed explanation on each KFSI, its purpose, importance and how it is measured may be found in the FSI's methodology.[16]

Using the FSI

A wide range of actors use the FSI for different purposes. The media usually focuses on the FSI ranking, highlighting the top jurisdictions and notorious changes between each edition of the FSI. Activists and investigative journalists use all materials (the ranking, narrative reports and sometimes the detailed technical reports on each jurisdiction) either as part of their campaigns, to identify specific issues that need a solution, and as a source of examples and arguments when writing their own investigative reports. Tax authorities use the FSI when drawing their national tax haven lists and also before signing tax treaties containing exchange of information provisions, such as double tax agreements. The FSI helps them understand whether the partner jurisdiction will be able to provide information when requested, and thus assess whether it makes sense to sign a treaty at all or to exclude that jurisdiction from the national tax haven list. The FSI proves that, regardless of the text of the treaty – which may be perfectly well written – the future partner jurisdiction may not be able to effectively reply to a request for information if it does not have the information available in the first place, because its legal framework does not require its collection or registration.

In addition, law enforcement authorities use the FSI's detailed technical reports to find out how to access company information available in jurisdiction's online commercial registries, and how much information they are likely to obtain, in investigations which involve entities incorporated abroad. Banks and banking supervisors may use the FSI to assess the risks of specific company types from each jurisdiction, in the process of know-your-customer and anti-money laundering due diligence when opening a new account. Lastly, prosecutors use the FSI ranking before courts when trying to explain the risks of money laundering or tax evasion referring to certain entities incorporated in major financial centers, such as the United States, given that these major countries are hardly ever mentioned in national tax haven lists.

[16] http://www.financialsecrecyindex.com/PDF/FSI-Methodology.pdf

Chapter 4

Exposing Corporate Tax Practices: How to Structure Research and Build a Company Case Study

Based on the session facilitated by **Martin Brehm Christensen,** Action Aid.

Exposing Corporate Tax Practices: How to Structure Research and Build a Company Case Study[17]

A case study of a company could be useful to understand how companies hide their income to evadeor avoid taxation.

Objectives:

1. Company cases can serve as a suitable tool to highlight the abuse of international tax rules (bilateral treaties, abusive tax regimes of tax havens and transfer pricing) by multinational companies, especially in the developing world.
2. A company case can give evidence of the loss of revenue to developing countries and the consequences thereof.
3. It could potentially deter MNCs from engaging in tax avoiding practices as a company case would affect the reputation of the company.

Success Indicators:

1. A compelling and clearly communicated case study gets used and disseminated by academic researchers, civil society organizations and advocacy groups.
2. The government is forced to investigate the concerned company, or to take steps to amend laws.
3. A well-constructed case-study report attracts broad media coverage.

Risks:

1. The research may not generate enough evidence and may result in a waste of resources.
2. The story may get broken ahead of its launch by involved allies of the campaign. This will affect mobilization and the impact of the study.
3. The featured company/companies may take legal action, which is a concern.
4. The group bringing out this report may be perceived as 'anti-corporate', thus affecting its fund raising efforts in the future.

[17] This chapter is based on the session facilitated by Martin Brehm Christensen, ActionAid.

Looking at Databases: How to Obtain Information

After the selection a company or a few companies (see Annexure 1 for selection criteria), the next step involves analysing relevant databases. However, in some cases obtaining relevant information could require significant amounts of investment in terms of time, energy and resources.

In order to analyse the tax practices of a company, it is essential to scrutinize at least two documents – the company's Annual Report or its Financial Statements, along with its Annual Return Report. The former contains information on a company's accounts and the latter contains basic information about the company's registration, ownership etc. However the research should not be limited to these two documents and aim to gather as much information as possible.

Some important sources to obtain information are:

Online databases: Some relevant information about a company or its subsidiary might be available online and need some amount of research. There are several online databases – some that are free, whereas others charge an access fee – that have information on companies. Some civil society organizations also maintain tax related information. An online directory with links for different countries can be accessed at http://taxtracker.attac.se.

Company websites: For public limited and publicly traded companies, it is mandatory to have their account reports in the public domain. However, these databases generally provide aggregated information of various subsidiaries of a particular multinational corporation. Often, the tax dodging practices are carried out through few subsidiaries, in which case aggregated information does not serve the purpose. Hence, it is crucial is to have unconsolidated report of each subsidiary. However, with the implementation of Accountancy and Transparency directives, it is mandatory for MNCs involved in extractive and logging sectors to report country-by-country, company-by-company and project-by-project information, making it easier to obtain disaggregated data.

Official Registers: Official registers are maintained by government agencies, containing information about companies. In most developed countries these registers are maintained by the State Corporate Registrar or the Securities Exchange Commission (SEC), and information can be obtained after paying an access fee. Some developing countries have also made these databases available online; however, these databases are not well maintained. Furthermore, some countries have placed various restrictions on the access of such data. In some cases, only lawyers can access this data.

Analysing the Non-consolidated/ Individual Annual Reports – Getting to know the company: A lot of information can be gathered from the webpages of the parent company as well as its subsidiary company. Secondary sources (e.g. news articles written about the company) could be used to collect secondary information. The focus should be on information that relates directly with the economic performance of the concerned company. It is important to focus on the firm's past performance as there might be some anomalies in certain years in the economic performance of the company pertaining to specific investment decisions it made. While there can be legitimate reasons for the changes in the account books from year to year, it is important to corroborate such changes with prevailing circumstances. Research has shown that many a times, in order to shift profits from one jurisdiction to another with the aim of avoiding tax, big corporations create shell companies, which are legal on paper but do not have any physical operations. Additionally, it is only by focusing on long term trends that tax avoidance practices become clear.

Doing a Health Check: Asking basic questions regarding the company (e.g. is it profitable? or what is the effective tax rate for a subsidiary located in some developing countries?) once account books have been scrutinized could help with a 'health check' of the company. If the accounts reveal that although the firm is not making any profits and has huge debt, and is growing rapidly, then there is need to dig deeper as the actual profits earned can be easily manipulated. It is also important to focus on the effective rate of taxation for such corporations. If there is disparity between the effective tax rate paid by a corporation and the prevailing tax rate of the country in which it is operating, further analysis is required.

Tell-Tale Signs / Red Flag of Tax Dodging: Transfer mispricing in related party transactions is a widely used practice for the purpose of tax dodging. A large number of related party transactions in account books need to be scrutinised further to ascertain that these transactions have not been carried out for dodging taxes. In addition to 'receivables' and 'payables' under the related party balances, it is also important to analyse the balance sheet to see the extent of thin capitalization, especially on the debt incurred through related parties.

Chapter 5

International Standards for Exchange of Information between Jurisdictions

Based on the session facilitated by **Andres Knobel,** Tax Justice Network, titled 'Automatic Exchange of Information: The End of Banking Secrecy?'.

International Standards for Exchange of Information between Jurisdictions[18]

Tax havens and other secrecy jurisdictions facilitate the generation of illicit financial flows by allowing individuals and legal entities to hold their assets in these jurisdictions without disclosing their identity to their home jurisdictions. As a result these individuals and entities can evade or avoid taxes, or hide proceeds of corruption, launder money or commit other market abuses. In other cases, individuals use secrecy jurisdictions to hide their identity behind layers of companies and trusts, so that even if their assets held in different jurisdictions are discovered, they would still remain unidentifiable. Therefore, authorities in one country need to obtain information from financial institutions or commercial registries from other countries to find out where their residents are hiding their assets (or themselves). However, tax authorities from one country cannot simply go to a different country and request information from a bank or from the commercial registry. They need to ask the other country's authorities for this information. Even so, authorities cannot simply ask any country's authority for data. A legal framework for the exchange of information is necessary, such as an international agreement between both jurisdictions which allows for such an exchange of information and which determines how that exchange will take place (method, conditions, scope, etc.).

There are three methods to exchange information, viz. **i) upon request, ii) spontaneous and iii) automatic information exchange (AIE).** However, before discussing the three aforementioned methods in more detail, let's take a brief look at the different legal frameworks for such international agreements.

Legal frameworks:

1. **Double Tax Agreements (DTAs):** The OECD and UN Model (bilateral) Agreements to avoid double taxation (to prevent a company or individual from being taxed twice by two jurisdictions for the same income, transaction, etc.), also contain provisions for the exchange of information. Article 26 of the model DTA has a provision to exchange information 'upon request' - although it would be possible to include other methods too, such as spontaneous or AIE. Model Article 26 has been updated and improved, for instance to prevent a jurisdiction from invoking "banking secrecy" laws as a reason not to exchange banking information. Nevertheless, not all existing treaties contain the updated Article 26. This means that even when

[18] This chapter is based on a session facilitated by Andres Knobel, Tax Justice Network, named "Automatic Exchange of Information: The End of Banking Secrecy?"

jurisdictions have agreements which contain exchange of information provisions, they may still not be able to access and exchange information in practice. This would also happen, regardless of the text of the DTA, in cases where the jurisdiction does not collect information in the first place.

DTAs may not prove very efficient for developing countries, as these agreements often cause a reduction in their revenue. The problem is that in order to avoid double taxation, DTAs determine which of the two partner jurisdictions will have the right to levy tax in specific situations. Not surprisingly, the OECD Model DTA tends to favour rich countries' right to levy taxes.[19] Moreover, DTAs usually require jurisdictions to lower the withholding taxes they apply whenever a foreign company (which operates in the developing country) sends or pays back dividends, interests or royalties to its parent company abroad. Although withholding taxes tend to be an important source of revenue for developing countries, they are forced to reduce them if they want to sign an agreement with exchange of information provisions. In other words, developing countries, either hoping to receive foreign direct investment or information from abroad are forced to reduce their revenue upfront, even though they may still not receive any information in practice for reasons that will be explained below. Interestingly though, DTAs have shown to affect developed countries too, since multinational companies usually exploit them through a process called treaty shopping, where companies choose to incorporate subsidiaries in different jurisdictions to take advantage of their DTA's favourable provisions, and this – combined with other tax avoidance strategies – results in cases of double non-taxation, where multinational companies are eventually not taxed in any of the jurisdictions where they operate.

2. **Tax Information Exchange Agreement (TIEA):** The model bilateral Tax Information Exchange Agreement (TIEA) is another legal framework promoted by the OECD (for exchange 'upon request'). A TIEA model has also been designed by the Inter-American Center of Tax Administrators (CIAT) which provides the possibility for automatic and spontaneous exchanges.[20] The TIEA is specific for information exchange and does not include provisions to avoid double taxation. Thus, there is no risk of loss of revenue in this case.

   Both aforementioned models are bilateral and therefore have high costs associated with them, as a country has to sign separate treaties with all the countries concerned. These models also have other implications; for example, if a developing country wants to engage in exchange of information with a developed country, it is not very difficult for the developed country to impose its own stipulations on such an exchange, and also to insist ona DTA being signed rather than a TIEA.

3. **Council of Europe OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Tax Convention):** The Multilateral Tax Convention contains clauses for the three methods of exchange of information: 'upon request', spontaneous and automatic. However, it contains a caveat for AIE. Before the latter may take place, an additional agreement or memorandum of understanding is needed among jurisdictions which want to exchange information automatically with each other.

[19] http://www.taxjustice.net/topics/corporate-tax/tax-treaties/

[20] http://www.taxjustice.net/cms/upload/pdf/Tax_Information_Exchange_Arrangements.pdf

The main benefit of this Convention is its 'multilateral' basis, which solves many of the costs and risks associated with bilateral treaties. However, it is not clear if the process to join the Multilateral Convention (it requires an invitation and acceptance by current co-signatories) could prevent some developing countries from becoming party to it, although many have recently become party to the Convention.[21] Moreover, the Multilateral Convention was amended by a Protocol, but not all countries have signed the Amended Convention (notably, the Unites States), so it appears that there would be no legal framework for the exchange of information among those jurisdiction which are only party to the Original Convention and those which are party to the Amended Convention. Likewise, many jurisdictions have signed the Convention, but have not ratified yet, so it is not in force for them.

4. **The Federal Account Tax Compliance Act (FATCA):** FATCA is a law of the United States of America which requires all financial institutions in the world to send information to the US tax authorities (the Internal Revenue Service or IRS) about American entities' and individuals' financial accounts abroad. FATCA seems to contradict what has been explained before, that a jurisdiction cannot simply go and ask a bank abroad for information. The US “solved” this by imposing a 30% withholding tax on US based payments against any financial institution in the world that did not comply with FATCA. In other words, only the US could probably do something like this, since almost any relevant financial institution in the world has a presence or is related to the US financial system. In any case, banks and other financial institutions abroad, while they wanted to comply with FATCA, faced their own local laws which prevented them from disclosing their clients' information to the IRS. For this reason, the US signed FATCA Inter-government Agreements (IGAs) to provide a legal framework for the exchange of information. Three different IGA models were developed: Model 1 A, Model 1 B, and Model 2. Model 2 is based on FATCA original law, requiring financial institutions abroad to send information directly to the IRS. Model 1 requires financial institutions to send information to their own tax authorities, because the exchange of information takes place among authorities (not directly from the banks to the foreign tax authorities). In Model 1 B, information only flows from the foreign country to the US via the foreign country's authorities, not directly from the foreign banks to the IRS. Model 1 A – where exchanges are again among authorities - however, is the only of the three treaties that contemplates some kind of reciprocity, where the US will send some basic information back to the foreign country. A lot more information would however still flow to the US.

5. **European Union Saving Tax Directive (EUSTD):** The EUSTD was the first multilateral framework for AIE, although participating countries could impose a withholding tax instead of needing to exchange information, thus allowing tax evaders to remain anonymous. It was implemented by EU countries and other related territories,[22] but it only covered exchange of information regarding interest paid to individuals – it was thus ridden with loopholes.[23] The UESTD has now become obsolete, since the EU will implement the revised Directive of

[21] http://www.oecd.org/tax/exchange-of-tax-information/Status_of_convention.pdf
[22] http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/SEC%28 2008%292420.pdf (page 10, last paragraph).
[23] http://www.taxjustice.net/cms/upload/pdf/EUSTD-TJN-Briefing_-_JAN-2011.pdf

Administrative Cooperation (DAC) which includes automatic exchange of financial account information (as required by the OECD's CRS explained below) and other cases of income (insurance companies, director's fees, etc.).

6. **Rubik Agreements:** Rubik agreements were an attempt by Switzerland to stop the spread of automatic information exchange by promoting treaties which imposed a withholding tax against tax dodgers instead of needing to exchange information about their identity. Switzerland managed to sign one such agreement with the United Kingdom, but as it was warned by TJN in this paper,[24] the many loopholes included in the Rubik agreement prevented the UK from receiving most of the expected funds. Fortunately, Rubik agreements were prevented from becoming a global standard when Germany rejected to sign one with Switzerland, with the advent of FATCA and later with the OECD's CRS. However, it remains to be seen how Rubik agreements, which are in force between Switzerland and the UK and Switzerland and Austria, will operate once the CRS becomes applicable among these countries.

Information Exchange Methods and standards

Methods for exchange of information determine how information has to be exchanged, and in some cases how it has to be requested. Jurisdictions may simply exchange information as they see fit, or most likely, exchange information according to international standards. The most widely used method for exchange of information is 'upon request' and it is based on the OECD's standard contained in article 26 of its Model DTA and in TIEAs. The OECD Global Forum on Exchange of Information reviews jurisdictions' legal framework and compliance with this standard. However, a new method is fast becoming the global norm – automatic information exchange. This method could be implemented according to the FATCA standard (contained in FATCA law and the IGAs) or according to the OECD's Common Reporting Standard (CRS), which is based on IGAs but has been adapted for a multilateral framework, and was subject to other changes.

The exchange of information among authorities depends on cooperation and political will. While civil society organizations and developing countries' authorities may be interested in more disclosure of information – and easier access to it – tax havens and secrecy jurisdictions with major financial centres may want the opposite. For this reason, they impose many obstacles to reduce the effectiveness of the exchange of information itself or to prevent other countries, especially developing countries, from accessing the information.

A. Upon Request

Under this standard, a jurisdiction which wants to receive information from abroad has to ask for it first. This request has to be very specific in order to successfully obtain the information (the investigated taxpayer has to be identified, its bank account or bank or intermediary also has to be identified, the jurisdiction must prove the relevance of the information, what it has done to try to obtain it, etc.). Given that it is quite easy for tax dodgers to hide their assets and identities in tax havens, it is rather impossible or very demanding in time and resources for authorities to collect

[24] http://www.taxjustice.net/cms/upload/pdf/Italy_-_Rubik_background.pdf

the necessary information about a taxpayer, before a request can be made. In other words, requests are based on information that was somehow obtained – maybe as part of a different investigation or provided by a whistle blower, and the request of information usually helps to merely confirm suspicions. Importantly, the 'upon request' standard does not allow 'fishing expedition'. For example, Indian tax authorities would not be able to ask Swiss authorities to pass on all the information they have about Indian citizens who hold bank accounts in Swiss banks. Neither could the Indian authorities ask for all the information pertaining to a particular individual. The information requested has to pertain to specific persons and prove the relevance of the information requested. However, even with all the information provided, the Swiss could still reject the request. This happens for example, if the Swiss authorities do not have access to banking information under that specific agreement or if the request was based on information provided by a whistle blower. While this goes against the international standard, the Swiss would invoke their domestic laws and refuse to answer.

In other cases, tax havens may simply not have the information or the powers to access it, or they may decide not to use compulsory powers to obtain it, or either willingly or not, they could simply take too long to answer. While requests should be answered within 90 days – or an update on the status should be provided, there are cases where requests took more than two years to be answered, rendering the information useless for the requesting jurisdiction. In addition, more obstacles may prevent the actual exchange of information or its effectiveness. For example, either jurisdictions or their banks could tip-off taxpayers about an investigation against them (this could take place before or after the exchange of information, and in some cases full access to the request of information is provided to the investigated taxpayer). Countries like Andorra, for instance, would go to great lengths to ensure that the taxpayer is notified about an investigation. After such notification, either the taxpayer or the holder of information, i.e. the bank could go to courts and appeal against the exchange of information so as to postpone or even impede the exchange. Meanwhile, trusts and company service providers operating in some countries may be bound by 'flee clauses' – i.e. if they are informed that a tax authority of a country desires tax information involving these companies or trusts, they might shut down operations, erase the evidence and move elsewhere. This means that even if information is eventually exchanged, by the time the requesting jurisdiction receives any evidence, it may be too late to do anything (the taxpayer has already opened a new bank account, under a new company in any new jurisdiction). Lastly, the 'upon request' standard may be flawed from the 'demand' point of view. Since information will only be answered for specific requests, jurisdiction which suffer from corrupt regimes may find that requests are only made regarding opposing political officials, but not regarding the ruling party or the elites.

B. Spontaneous

Spontaneous exchange of information is more on an ad-hoc basis, and there is no certainty associated with the standard. It basically allows jurisdictions to exchange information with each other whenever they come up with any data which may be relevant for the other jurisdiction.

Given the aforementioned reasons, spontaneous exchange is used infrequently and is less relevant than 'upon request' and AIE standards.

C. Automatic Information Exchange (AIE)

Automatic information exchange is different from the 'upon request' standard because it supposes frequent exchanges of information without the need to request it, and about many taxpayers at the same time, although the scope and conditions will depend on the specific standard used. The only relevant standard for global AIE is the Common Reporting Standard (CRS) devised by the OECD in February 2014. Subsequently, the OECD brought out Commentaries to the CRS which carried interpretative guidelines. In 2015 more than 90 jurisdictions had committed to implement the CRS. However, commitment is not enough, and –as it was explained above – a legal framework is needed before AIE may take place. The U.S. however, has already declared that it will not implement the CRS, but only FATCA and the IGAs, which involve more information flowing to the US than on the other direction, if anything at all.

i. A double legal framework for AIE

The OECD Multilateral Tax Convention forms the (ideal) legal basis for the CRS because a multilateral framework is a better fit for "global" AIE. However, bilateral DTAs or TIEAs between countries could also be signed or re-negotiated to accommodate the standard. In any case, an additional legal framework is needed, especially if the Multilateral Tax Convention serves as the legal basis. As it was explained above, for AIE to take place- an additional Memorandum of Understanding (MoU) is needed. For this reason, the OECD also developed a model Competent Authority Agreement (CAA), which serves as the required MoU. Both a model bilateral and multilateral CAAs were developed. Fortunately, most countries have signed the Multilateral CAA (MCAA), but nothing prevents some countries from signing either another regional MCAA or directly bilateral CAAs. Bilateral CAAs would be subject to the same costs and risks of inconsistencies as bilateral agreements in general, which is why the MCAA is a better option.

ii. Mechanism of the AIE

Banks and other financial institutions are central to the CRS, and are primarily responsible for the collection of information about their account holders. They will need to submit all the collected information to their own authorities. After receiving information from all the local financial institutions, authorities will then compile the data and sort it according to jurisdiction of residence. They will then exchange the information with the corresponding foreign authority. This shows the benefits of AIE: under the CRS, in theory, AIE will take place every year without the need for the recipient jurisdiction to make a request or gather information beforehand, and about all the residents (not just about one specific taxpayer), as long as the jurisdiction where the account holders are resident is participating in the CRS. The risk of political influence is decreased substantially too, as banks and tax authorities of the countries providing information cannot use their discretion to selectively provide information. The question, however, is what recipient jurisdictions will do with the information after they receive it – and that is the reason why statistics or some sort of disclosure of non-confidential information will also be necessary to track the effectiveness of the AIE and the work of authorities. This would help prevent cases like the scandal disclosed by Swiss Leaks, which showed that authorities which received data on tax evasion from the whistle blower Falciani did very little to investigate or prosecute those responsible for tax evasion and other crimes. However, in spite of the questionable effectiveness of authorities, AIE should have a deterrent effect against tax evasion, since tax dodgers (or criminals hiding for other purposes) know that their information will be obtained by incumbent or future authorities who may end up using it after all.

iii. Limitations in the MCAA (preventing access to AIE)

The CRS and MCAA require full reciprocity, meaning that all participating jurisdictions need to send information to other jurisdictions, if they want to receive information. This will exclude developing countries which do not have the technical or staff capacity to collect and send information – although they would have benefitted if they could simply receive the information about their residents' hidden foreign accounts. Moreover, all jurisdictions need to prove that they have the necessary legal framework to implement the CRS, that they meet with extra confidentiality provisions (more demanding than those for the upon request standard) and that they meet with any subjective requirements for the protection of personal data imposed by the sending jurisdiction. Lastly – and most importantly – the MCAA imposes a condition similar to a 'dating system', where jurisdictions must choose each other, and thus, AIE will only take place where two jurisdictions were matched. This means that if, for example, India signed the MCAA, met all the confidentiality and legal framework requirements and chose to exchange information with all other signatories of the MCAA, but no other jurisdiction chose India back, then India will not receive (or send) any information. This dating system will easily be exploited by tax havens, who will cherry-pick the jurisdictions with whom they want to exchange information, and will very likely exclude developing countries. Switzerland and the Bahamas have already implied they will pick only specific countries.

iv. Limitations in the CRS (preventing its effectiveness)

Even for countries that manage to pass all of the MCAA obstacles and implement the CRS, many loopholes and exclusions will prevent it from being truly effective to stem tax evasion and illicit financial flows in general.

First, the CRS only covers financial account information, but not gold, real estate, art, or even cash held in safe deposit boxes or at free ports. Second, only in specific cases will financial institutions need to identify the beneficial owners (natural persons hiding behind entities), and without central registries of beneficial ownership, this information cannot be verified either. Moreover, since the CRS is based on determining the residence of the account holders (to send their account information to the corresponding jurisdiction), the easiest way to avoid reporting is to pretend to be a resident from a different jurisdiction. Some tax havens are offering residency certificates in exchange for money, allowing people to live and work where they are, but they may use the acquired certificate of residence (relating to a tax haven) to convince their banks that they are resident in that tax haven, so that their information will be sent there (to the wrong jurisdiction, where they do not have to pay any tax). Lastly, there are thresholds below which there is no exchange of information, as well as other exclusions for start-ups, some trusts and other entities which may escape reporting. For more information on the loopholes and exclusions affecting the CRS effectiveness and suggested solutions, see TJN's papers on AIE.[25]

v. Opportunities for excluded developing countries: pilot programs and statistics

Developing countries which are unable to implement the CRS because of staff and other capacity limitations, may join the Global Forum pilot projects which consist of partnering up with a developed country to start preparing for AIE and obtaining some information. This framework is supposed to be more flexible (though also less comprehensive in terms of the exchanged data), but may allow cases of non-reciprocity where the developing country will first only receive information without needing to invest resources in having the legal and IT framework to send anything back.

In addition, TJN together with other organizations is promoting a template for AIE statistics to be published by major financial centres. These statistics would inform, in an aggregate basis (without identifying anyone and thus not compromising any confidentiality), how much money is deposited in each financial centre, sorted by jurisdiction of residence. This way, any jurisdiction not yet participating in the CRS, would still be able to know how much money, in total, their residents hold in each of the world's financial centres. This information could also be used to track data to identify cases of avoidance and to measure the CRS effectiveness in general.

These statistics will require no extra costs because they are based on the information that financial institutions already have to collect and submit. It merely requires information to be added together, and to publish those "totals" sorted by jurisdiction of residence. Civil society organisations are hoping to obtain support for this proposal to push financial centres to publish these statistics which could have a decisive role in curbing illicit financial flows.

[25] http://www.taxjustice.net/wp-content/uploads/2013/04/TJN-141124-CRS-AIE-End-of-Banking-Secrecy.pdf and http://www.taxjustice.net/wp-content/uploads/2013/04/OECD-CRS-Implementation-Handbook-FINAL.pdf.

Chapter 6

Regional Perspectives

A. EU Perspectives

B. Base Erosion and Profit Shifting in India

C. Transfer Mispricing with a Special Focus on Argentina

A. Based on the presentation given by **Koen Roovers,** Financial Transparency Coalition.

B. Based on the presentation given by **D. P. Sengupta.**

C. Based on the presentation given by **Veronica Grondona,** CEFID-AR Argentina.

Regional Perspectives

This chapter will give an overview of some of the initiatives of the European Union to address these issues. The second regional perspective is an synopsis of the BEPS initiative in the Indian context and a discussion of its limitations for developing countries. Finally, there is a brief discussion of the Argentinian legal system's evolution in relation to addressing transfer pricing.

EU Perspectives[26]

Numerous financial investigations have revealed that it is common practice for money launderers, corrupt politicians, tax dodgers and traffickers of all sorts to use anonymous legal entities to move their illicit proceeds. In doing so, these entities often require professional bankers, lawyers and accountants that are willing to help them to efficiently manage their assets. The true beneficiary of such assets may take refuge behind complicated corporate structures that can be liked to a Russian doll: a company within a company within a company, and so on, which makes the uncovering of the true nature of transactions and their beneficiaries very difficult. Although banks are supposed to comply with 'know your customer' (KYC) rules, background and anti-money laundering checks, they either do not have the desire or don't spend enough resources to do so. The Financial Action Task Force (FATF) - an international standard setting body for combating money laundering- estimates that as much as 2.7 per cent of global GDP is laundered worldwide in connection with criminal activities. Furthermore, a study by the World Bank estimates that over 70 per cent of large-scale corruption cases involved anonymous companies.

As the modus operandi of illicit financial flows is essentially a part of a structural problem rather than aberrations, ensuring effective anti-money laundering legislations are in place towards correcting these problems lie at the heart of the matter. The European Union (EU) has been the standard-bearer on the issue of anti-money laundering in recent times. The anti-money laundering directives have been present in Europe since 1990s. In February 2013 this directive was reviewed for the fourth time making money laundering and terrorist financing its main focus, and in June of the same year it passed new Accounting and Transparency directives that would help enhancing transparency of payments to governments by logging and extractive industries, by obliging resource extracting companies to mandatory report on their payments to governments on a country-by-country basis. In December 2014, in an important step, the European Union reached on an agreement to create national registries of the

[26] This sub-section is based on a presentation given by Koen Roovers, Financial Transparency Coalition, named “Home of the Irish-Dutch-Sandwich, Lux Leaks, Swiss Banks and the City: What Can We Actually Learn from Europe About Financial Transparency?”.

beneficial owners of companies and trusts. The registers for companies will be accessible not only to law enforcement and obliged entities (i.e. companies that fall under KYC rules), but also to the public when a legitimate interest can be proven.

Our objectives

Public Registers of Beneficial Ownership

The Financial Transparency Coalition (FTC) has been advocating for public disclosure of the beneficial owners of corporate vehicles through the creation of public registers. To the FTC, this is a central requirement for ensuring greater transparency. Publicly available information will serve multiple purposes. It will be more difficult for corrupt individuals to hide behind a maze of anonymous shell companies. It will allow national authorities to better estimate and manage tax revenue as well as plan their proper utilisation. Further, by making it easier for investigators, the public, civil society etc. to uncover the source and intended destination for funds it will ensure proper and efficient use of resources. These will help bring about checks and balances in the system. It will also help improve the quality of data especially for police/ vigilance, as information available in the public domain would make it easier for people to flag irregularities. It will allow developing countries to ensure that they have full access to information about companies incorporated in Europe, with which their interests are aligned.

Mandatory Country-by-Country Reporting for all sectors

At the moment, multinational corporations' (MNCs) reports consists of economic and financial information: their profits, revenues, taxes, borrowings, employees record and so on are generally global figures; that is, these reports consist generally of aggregated data for their worldwide operations. However, implementation of country-by-country reporting, preferably both for large transnational listed and non-listed companies operating in all sectors would oblige them to present their accounts on a country specific basis, so that it would become clear, for example, how their profits and tax contributions relate to one another. This breakdown of these statistics lies at the heart of the transparency requirement – something that many civil society organizations and advocacy groups around the world have been demanding for a long time now. It is essential that citizens of each country know what MNCs and their affiliates are doing there. Furthermore, country-by-country reporting would throw light on many of the MNCs' international tax affairs whereby they manipulate transfer prices to shift billions of dollars into zero-tax or low-tax jurisdictions.

Previous campaigning and advocacy success

For extractive and logging companies: Accounting and Transparency Directives

There exists considerable opacity around the payments generated in the extractive sectors which makes it all too easy for the companies involved in extractive businesses to avoid and evade taxes as well as for corrupt government officials to siphon off or misappropriate funds. These companies are present almost everywhere. Thus, the information disclosed by these countries will have a wide ranging impact for most countries around the world. Under these existing directives, the Accounting and Transparency Directives, the concerned companies have to report on their payments to the respective governments. Further, the directive not only requires country-by-country reporting, but also project-by-project reporting without any exemptions.

For Banks: The 4th Capital Requirements Directive

Under this directive, the 4th Capital Requirements Directive (CRDIV), banks too are required to disclose information starting 2015. They are mandatorily required to report on the names of their subsidiaries and their geographical location, the nature of their activities, on their turnover, number of employees on full time equivalent basis, profits or loss before tax, tax on profits or loss and public subsidies received. This comprehensive list of information will shine light on various aspects of their functioning, including the use of subsidiaries and tax havens, which has so far been hidden from public oversight. This also holds opportunities for citizens outside of Europe, as the Big Banks that fall under this reporting requirement list fiscal and financial details for all their subsidiaries.

However, one should be very mindful, especially in the European Union, on how these directives are implemented at the national level. In case of requirements demanded from the banks on their subsidiaries, the directive has asked for disclosure of 'name(s)', which is then left to different member countries to decide on what they want from their banks. However, if a country chooses to just seek the name instead of names of the subsidiaries, it is possible that many banks would choose not to provide names of those subsidiaries that are engaged in suspicious activities (that is, they could choose to put innocent aspects of their financial activities on the table and conceal the others). Many important bits of information may be left out in this case. Different countries have included this in their national legislations in different ways. For example:

- **UK, Austria, Belgium** and **Netherlands** modified 'name(s)' to singular-name so banks are required to just name one subsidiary in another country. This is problematic since it will not provide a complete picture.
- **Italy** chose to incorporate in its national legislation the 'name of societies or enterprises' which is an improvement over the aforementioned four countries.
- **Germany** has incorporated the directive in its national legislation as 'names of the companies'.
- **Spain** and **Portugal** have incorporated it as 'where the company is established and per economic exercise'. This is a better description for transparency requirements.
- **Luxembourg** and **France** have made no changes in wording.

This demonstrates how general consensus carries over or is transposed into national level and why it is very important to monitor how these directives are put into national legislation especially when the decision-making body is inter-governmental.

Base Erosion and Profit Shifting in India[27]

Implications for Developing Countries

Base Erosion and Profit Shifting (BEPS) is a technical term, which refers to the negative effect of multinational companies' tax avoidance strategies on the tax bases of different jurisdictions. There are several channels through which MNCs can indulge in tax base erosion in the countries in which they operate and also shift profit from a high tax jurisdiction to a low tax one. Some of the most common means of doing so are through the use of transfer pricing; use of Special Purpose Entities (SPEs) and through hybrid mismatches.

Hybrids are used when the same transaction is treated differently (for instance, as debt or equity) by different countries. In the process, in many cases, the result is double non-taxation.Hybrids may also feature dual residence-companies that are residents of two countries for tax purposes. An SPE is an entity with few or no employees, little or no physical presence in the host economy and whose assets and liabilities represent investments in or from other countries and whose only business often consists of group financing or holding activities.

Transfer prices are the prices various parts of a company pay each other for goods or services. They are used to calculate how profits should be allocated among the different parts of the company in different countries, and are used to decide how much tax the MNC pays and to which tax administration. The loopholes that these MNCs look to take advantage of largely come from the tax treaties between countries. Since in most cases, these MNCs are situated in developed nations but most of their economic activity is in developing nations, the BEPS process has huge implications for developing countries. These mechanisms erode the revenue base of developing countries, depriving them of tax contributions they need, to meet the needs and rights of their people, and fund their own development.

The OECD has acknowledged this problem, and has taken up the BEPS project. Through this initiative, it has listed out six key pressure areas and fifteen action points to focus on. These six pressure areas are: developing rules for digital economy, prevention of double non taxation, alignment of economic activity and taxation, tax transparency that includes exchange of information, dispute resolution and effective implementation.

However, it has been alleged that the emphasis of the BEPS project appears to be on issues of current primary concern to richer countries, such as tax issues thrown up by the border less digital economy. While the issue of corporate tax avoidance has been attributed importance, there is no talk about the distribution of taxing rights between the source and resident countries- the issue most crucial for developing countries. Additionally, many developing countries have opposed the inclusion of arbitration as means of dispute resolution. It has been argued that developing and less developed

[27] This section is based on a presentation given by D. P. Sengupta, Former Jt. Sec. of the Tax Department, Ministry of Finance, Government of India, and Consultant, National Institute of Public Finance and Policy.
This presentation was based on a paper co-authored by him:
http://www.nipfp.org.in/media/medialibrary/2014/03/WP_2014_133.pdf

countries do not have the expertise and resources to ensure a fair outcome in such proceedings. Besides, in the context of investment treaties, historically arbitration results have been against these countries.

The Indian Case

Under the Indian Income Tax Act, 1961, the country's tax base is defined as "all incomes from whatever sources derived". However, if the persons /group concerned are non-resident, then only that income, which is earned in India falls under tax base or can be taxed; what accrues to them outside India is not taxable in India.

Since the early 1990s when the Indian economy opened up, the scale and magnitude of its integration with the world economy has grown significantly. India, labour-abundant and rich in natural resources, with a huge market, has attracted many foreign corporations' attention. Recently, there has been a steep increase in the inflows of Foreign Direct Investment (FDI) to India. With greater integration of the domestic economy with the world economy, issues of international taxation have acquired a lot of significance in the domain of policy making.

Tax Base Erosion in India: A worrying feature of the FDI coming to India is that over 53% of it comes from low tax jurisdictions, particularly Mauritius, Singapore, UAE and Cyprus. Therefore, there is scope of manipulation and tax base erosion when FDI flows come from such non-transparent jurisdictions. This is particularly worrying for India that depends to a very significant extent on corporation tax. Corporation tax collections in India from 1980 onwards has been increasing, and in 2011 it stood at around 3% of GDP and 34.6% of total tax revenue. This percentage is much lower for the OECD countries. Hence, tax base erosion by MNCs has more significance for India.

As already noted, the major routes through which base erosion could take place are transactions with non-residents, through interest payments, royalty payments, head office management services fees, fees for technical services and through transfer pricing. A study by Patnaik and Shah (2010) looking at whether the effective tax rate for Indian MNCs is lower than the effective tax rate for purely domestic companies, finds that this indeed was the case. Another study by Jansky and Prats (2013) demonstrates that MNCs operating in India with tax haven connection report 1.5% less profits; pay 17.4% less in taxes per unit of asset; pay 30.3% less in taxes per unit of profit and have 11.4% higher debt ratios than MNCs with no connection to tax havens. In case of royalty and interest payments, Rao and Sengupta (2012) have shown that there are differences in behaviour of domestic and non-domestic[28] companies with the latter showing higher levels of both interest payments and royalty payments corresponding to given levels of borrowings and sales respectively. The royalty payments especially, increased after 2009, after the limits to royalty payments were removed.

[28] The difference between domestic and non-domestic firms is that the latter has reported transactions under any of the following six category classification provided by PROWESS database on related party transactions: holding company, subsidiary, parties where control exists, key personnel and relatives of key personnel and others.

These studies indicate that there is evidence of base erosion from India. There are several court cases on these issues in India and the judgments have sometimes been in favour of tax authorities and other times in favour of corporations. It is important to know the details of these cases and arguments for more informed debate on the current state of play and how developing countries like India are struggling to tax MNCs. Two such case studies are illustrated in the Annexure.[29]

Transfer Mispricing with a Special Focus on Argentina[30]

Although economists have been talking about the problem of transfer pricing, an unambiguous definition of the term has still not been attempted. Price, in legal terms, is a form of contract. And a contract implies a negotiation between two independent parties. Therefore, if two parties are not legally independent, then there is there is one party and another one subject to it. Consequently, the price of transaction between two parties within the same economic group is not a legal contract.

However, we do have related party transactions within an economic group. Very often multinational companies constitute themselves in a way as to have related parties located in different countries and perform operations between them. These transactions include financial transactions (loans, derivatives, warrants, swaps etc.), acquisition and sale of final and intermediate products, raw materials and capital goods, acquisition and sale of affiliated companies, technology transfer, research and development and services rendered such as management and support. The pricing of these transactions is called transfer pricing.

The Case of Argentina: In Argentina, the question of valuation of the intra-group transactions came into picture in 1935 when a senator, in his speech at the Congress denounced the manoeuvres of the Anglo company to avoid taxation both in Argentina and England. In the subsequent years, many court cases relating to the issue of transfer pricing in Argentina discussed the concept of "economic reality". According to this concept what needs to be understood is the economic reality of transactions between two parties and not their contractual form, since such form would be affected by the economic relationship between the parties. Under the economic reality principle, if such transactions were performed within an economic group, the financial and royalty payment transactions would be understood as capital transfers (dividend distribution or capital investment). The doctrine was introduced in the laws concerning income tax (Law 20.628), foreign investments (Law 20.557) and technology transfer (Law 20.794) in 1973. According to these laws the contractual forms between two entities of same economic groups are not valid and financial contributions, royalties and services should be considered as capital transfers. In addition, (Law 20.557, article 18) companies belonging to foreign capitals that benefited from promotional regimes within the country, would not be able to repatriate capital while benefiting from the promotional benefits.

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[29] For more details and case studies, please see: http://www.nipfp.org.in/media/medialibrary/2014/03/WP_2014_133.pdf
[30] This section is based on a presentation by Veronica Grondona, CEFID-AR Argentina, on a paper by her: 'Transfer Pricing Manipulation and Capital Flight', VI Congreso 2015 "El futuro del desarrolloargentino". Fernando Peirano (comp.), Asociación de Economíapara el Desarrollo de la Argentina (AEDA); available at http://www.aeda.org.ar/

Soon after the military coup that initiated the dictatorship regime of 1976-1983, these laws were modified in order to incorporate the arm's length principle for tackling transfer pricing. According to this principle, when related parties within the same corporate group trade across borders with each other, it is possible to establish an 'arm's length' price for transaction, as if they were independent unrelated entities trading in a genuine market. Changes in the legislations brought in during this time allowed for deductibility of intra-group payments as long as they were along the 'normal' practices between independent parties. Even after the dictatorship ended, the legislative framework remained the same, and in 1998 it was backed up by a legislative change that introduced OECD's recommended transfer pricing methods.

In 2003, the Sixth Method was implemented, for the estimation of the transfer prices in the case of commodities exports performed through international intermediaries, when such intermediaries do not demonstrate to have economic substance. According to this method, the price in such transactions should be that of the market at the shipping day. Recently, OECD is also taking up the Sixth Method for extractive industry commodities and for developing countries that have a substantial contribution to the extractive industries trade in their exports.

The Sixth Method was introduced in Argentina because tax authorities found that in transactions between two related parties, commodities were not valued in future markets, but through intragroup contracts which were not reliable; and seemed always to benefit from a lower export price.

However, one of the problems concerning the application of this method is that the legislative framework mentions that this method is only valid in cases where there is an intermediary located in a non-cooperative jurisdiction and having no economic substance. All these things turn out to be quite tricky because companies can justify the existence of economic substance quite easily. At the same time it becomes really tough for Argentine authorities to check whether a company located in Cayman Islands for instance, has economic substance or not.

The other recent development that has turned out to be quite tricky is that of changing the negative list of tax havens into a positive list. The criterion has been changed to one of co-operative and non-cooperative jurisdictions. The jurisdictions considered as tax havens are now considered non-cooperative as long as Argentina has not signed or negotiated an information exchange treaty with them. Thus, all jurisdictions with whom Argentina has signed a DTAA or an information exchange treaty or is negotiating one, are now considered to be 'cooperative' (Communic. "C" 65.366 BCRA, 2014). Argentina now has around 109 cooperative jurisdictions.

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Annexures

1. eBay International AG Vs. ADIT:

eBay AG, incorporated in Switzerland, operates India-specific websites, providing an online platform for facilitating the purchase and sale of goods and services to users based in India. A seller is entitled to list their products for sale on the website on providing adequate details regarding the product that they wish to market through the website. A buyer can register themself for buying goods through the website and can choose a payment method to make a direct payment to the seller.

Once a buyer is registered, they can purchase items on the website by clicking 'Buy it now'. Ane-mail is sent to the seller confirming sale of the listed product. The seller then delivers the product to the buyer and settles the product's payment. Registered sellers are required to pay a 'user fee' on every successful sale of their products on the website. Sellers are required to make the payment for the user fee to eBay India/ eBay Motors for the transactions undertaken on the websites. After the collection from Indian sellers, eBay India/eBay Motors remit the user fee to the Swiss company.

For the assessment year 2006-07, eBay AG earned revenue amounting Rs. 4,94,27,530/- from the operations of its websites in India. eBay AG claimed that the revenue represents business profits and is not taxable in India since eBay AG does not have a permanent establishment (PE) as per the provision in Article 5 of the DTAA between India and Switzerland.

One of the arguments of the Indian revenue authorities in their efforts to tax foreign companies operating in India, was that eBay AG had a dependent agent PE in India in the form of two websites – eBay India and eBay Motors. An Indian tribunal held that there was no dispute about the fact that eBay India and eBay Motors had been providing their exclusive services to eBay AG (henceforth, the assessee). It has been admitted that they had no alternative source of income apart from those accrued by the assessee in exchange services, thus eBay India and eBay Motors definitely become dependent agents of the assessee.

The tribunal however, pointed out that eBay India had at no stage negotiated or entered into a contract for, or on behalf of, the foreign company. In process of providing services to the assessee or making collection from customers and forwarding the same to eBay AG, it cannot be said that eBay India entered into contract on behalf of the assessee. The Indian tribunal held that eBay India and eBay Motors do not routinely exercise an authority to negotiate and enter into contracts for or on behalf of the assessee, so under the extant rules, they could not be called dependent agent PE of eBay AG and the income accrued by the assessee cannot be taxed in India.

2. Nimbus Sport International Pvt. Ltd. Vs. DDIT:

Nimbus is an Indian enterprise in media and entertainment, and owns channels like Neo Sports and Neo Cricket. A company named Nimbus Sport International Pvt Ltd was incorporated in Singapore with no PE in India implying that it was wholly managed from Singapore. This entity entered into an agreement with Prasar Bharti for telecasting of cricket events from February 2002 to October

2004.The case was on the taxability of advertisement revenues from Indian advertisers- Coca Cola India Pvt Ltd, Hero Honda, Seagram Manufacturing Ltd etc. during the telecast of matches from Sri Lanka.

The Indian Tax Assessing Officer took the stand that Nimbus(henceforth, the assessee) had a PE in India and the source of the receipts lay in India, as the Indian team played these matches that were broadcast internationally including in India. The Assessing Officer adopted 20 per cent gross receipts from the advertisements, and estimated 50 per cent thereof as income attributable to the PE in India.

On appeal, the Commissioner of Income Tax (Appeals) observed that various companies in India like Coca-Cola, LG electronics, Pepsico Food etc. were in contracts with the assessee company for advertising their products. Since the company provided advertisement to various companies located in India via live telecast viewed by customers in India, income arising from advertisement was taxable in India. The officer also held that the advertisement income was u/s 9 (1) of the Indian Income Tax Act as the source was in India. Moreover, the officer held that Article 7(1) of DTAA between India and Singapore has incorporated the principle of 'force of attraction' based on the UN Model. Accordingly, the CITA held that the assessee had carried out the core activities of advertisement business through fixed place PE in India.

On appeal, the tribunal held that the contract was signed by the assessee in Singapore and all the activities relating to this contract were carried out from Singapore; there is no evidence to prove that the management and control of the affairs of the company were situated in India. The assessee's activities in Singapore demonstrated that the affairs of the company were wholly carried out in Singapore; that the residence of the two non-resident directors in India does not imply that the company is an Indian establishment. It was held by the tribunal that the taxpayer did not have a PE in India, the matches were not played in India, the telecast of the matches was not in India and the indirect benefit which might have been derived by some of the Indian viewers could not be held to be incremental for Indian companies' assumption. The tribunal held that the advertisement revenue had no attribution to India and in absence of any PE in the traditional definition of the term, this revenue could not be taxed in India.

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