ASAP Academics Stand Against Poverty

Institutional Reform Goals: Illicit Trade-Related Flows[1]

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Reforming the rules and regulations that facilitate illicit financial flows would have a major impact on human development. For this reason, ASAP believes that illicit financial flows are a crucial item for the international community to address in the post-2015 development agenda. This report focuses specifically on the rules and regulations that allow for illicit trade-related flows (as opposed to criminal and corrupt flows), and especially on the practice of corporate tax abuse (tax evasion and avoidance). It reviews measures currently in place or under discussion by the international community to address illicit trade-related flows. It then makes six policy recommendations for inclusion in the post-2015 agenda: reform the arm's-length transfer pricing system; reform international accounting standards; implement universal automatic exchange of information; require public registers of beneficial ownership; increase rate of stolen asset repatriation; and increase ODA for capacity-building on matters of tax.

[1] Thank you to Tom Cardamone, Gail Hurley, Krishen Mehta, Zorka Milin, Rachel Payne, Thomas Pogge, and Mitu Sengupta for commenting on earlier drafts of this paper.

There are many features of the international institutional order that (1) contribute to the persistence of global poverty and (2) could be reformed at a reasonable cost by the international community in a way that (3) would entail dramatic reductions in global poverty and human deprivation.[2] Academics Stand Against Poverty (ASAP) believes that reforming these institutional arrangements is a moral imperative and should play a central role in the United Nations' new development framework, which will succeed the current Millennium Development Goals (MDGs) when they expire in 2015. ASAP is therefore working to develop and advocate for politically feasible MDG successor goals that improve upon those in the original MDG framework—which focused primarily on social outcomes for the recipients of aid—by highlighting the responsibilities of affluent states to reform those institutions.

ASAP has identified ten aspects of the global institutional order, the reform of which could have a major impact on human development and poverty alleviation. One of these is illicit financial flows. For the purposes of this report, illicit financial flows are cross-border financial flows that are contrary to (the letter and spirit of) domestic and international laws.[3] There are three broad types of illicit flows: corrupt, including the proceeds of bribery and theft; criminal, including the proceeds of activities such as drug and human trafficking; and trade-related, including different kinds of tax-evading and tax-avoiding activities.[4] This report will look closely at the last of these and their effects on global poverty, with a view to suggesting various institutional reforms that should be incorporated into the post-MDG development framework.

Illicit trade-related financial flows, and especially tax-*avoiding* flows, are the focus of this report for two reasons. First, they account for the large majority of all illicit financial flows, and so curbing them has the greatest potential to generate new resources for the developing

[2] The term global institutional order is most strongly associated with Thomas Pogge. It refers to, in Pogge's words, "non-domestic social institutions" such as global rules of governance, trade, and diplomacy. See Thomas Pogge, "World Poverty and Human Rights: Cosmopolitan Responsibilities and Reforms" (second edition). Polity Press, Malden, MA, 2008. 33.

[3] This is following Global Financial Integrity, but there is no settled definition of illicit financial flows, and different people understand different things by the term. For a discussion of definitions see Peter Reuter, "Introduction and Overview: the Dynamics of Illicit Flows" in *Draining Development?* ed. Peter Reuter. The World Bank, 2012. 7. (Available here.)

[4] Again, following Global Financial Integrity, which has recently stopped focusing on criminal flows.

world.[5] Second, corrupt and criminal financial flows are the result of *violating* existing laws and rules. While large sums of money are lost to corruption and criminal activity each year, the existence of these behaviours does not in itself suggest problems with the rules trying to prevent them in the first place (although they may suggest problems with the enforcement of those rules). In contrast, illicit trade-related flows—specifically, the proceeds of corporate tax avoidance—are the result of problems with the structure of financial rules and regulations themselves and are thus an appropriate subject for institutional reform.

This report will focus on two main elements of illicit trade-related flows: corporate profit shifting and financial secrecy. It will proceed as follows. Section I makes the connection between illicit financial flows and development. It then explains corporate profit shifting and financial secrecy and shows how they harm the developing world. Section II provides a review of some current measures that have been or are being considered by the international community to reform the rules and practices that facilitate these illicit flows. Finally, Section III provides recommendations for a set of politically feasible post-MDG goals and targets aimed at reforming the rules and practices that make corporate tax abuse possible, specifically those rules and practices relating to corporate profit sifting and financial secrecy.

I. Illicit financial flows and development

Illicit financial flows drain huge amounts of resources from the developing world.[6] The most recent estimates from Global Financial Integrity (GFI), a pioneer in the study and quantification of illicit financial flows, is that illicit flows from developing countries totaled $946.7 billion in 2011 (an increase of 13.7% in their estimates from 2010), and totaled $5.9 trillion cumulatively from 2002 to 2011.[7] According to a recent United Nations Development Programme (UNDP) report, illicit financial flows are prevalent in the least developed countries (LDCs), where they have increased from $9.7 billion in 1990 to $26.3

[5] Dev Kar and Brian LeBlanc, "Illicit Financial Flows from Developing Countries: 2002-2011." GFI, December 2013. x. (Available here.)

[6] More specifically, "it drains hard currency reserves, increases inflation, reduces tax collection, widens income gaps, forestalls investment, stifles competition, and undercuts free trade." See Raymond Baker and Eva Joly, "The Issue of Illicit Financial Flows" in *Commentaire*, Hiver 2008-9, Volume 31, Numero 124, 7-8. (Available here.)

[7] Dev Kar and Brian LeBlanc, iii.

billion in 2008.[8] Moreover, GFI estimates that around 80% of illicit financial flows are due to illicit trade-related activities such as customs fraud through trade misinvoicing.[9] However, this figure does not even include the losses to corporate profit shifting through abusive transfer pricing, which is thought to be widespread. So in all likelihood losses to illicit trade-related flows are much greater than currently can be estimated.[10]

These estimates lump together two different types of losses caused by illicit financial flows: i) revenue losses (e.g. from taxes) incurred by developing country governments and ii) investment capital losses incurred by the economies of developing countries. The latter are much more difficult to quantify but they are also arguably much greater than the former. For this and other reasons there is disagreement over these figures (and the methodology used to generate them). But there should be no doubt that the losses to developing countries due to illicit financial flows are substantial. According to University of Maryland professor Peter Reuter, "Even if the correct figure is only a 10th of the often-cited Global Financial Integrity estimates…that is, around US$100 billion, it is large relative to either official development assistance (about US$70 billion) or total foreign direct investment in the developing world (around US$250 billion in 2004…)."[11] According to the UNDP report, the LDCs, which receive approximately 24.1% of total official development assistance (ODA), averaged a loss of 60 cents in illicit financial flows for every dollar of ODA.[12] Eliminating these outflows, then, would generate a lot more resources for developing countries, and could be of enormous benefit to the global poor.[13]

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8 UNDP, "Illicit Financial Flows from the Least Developed Countries: 1990-2008." UNDP, May 2011. 3. (Available here.) GFI defines trade misinvoicing as "deliberately misreporting the value of a commercial transaction on an invoice submitted to customs." See GFI, "Trade Mispricing." (Available here.)

9 Dev Kar and Brian LeBlanc, x.

10 Abusive transfer pricing occurs when MNCs shift profits amongst their subsidiaries in different tax jurisdictions at non-market rates in order to minimize their overall tax burden. (How this works is explained in more detail below). GFI's estimates on illicit trade-related flows do not include abusive transfer pricing because it is very difficult to detect.

11 Peter Reuter, "Policy and Research Implications of Illicit Flows" in *Draining Development?* The World Bank, 2012. 484.

12 UNDP, 18.

13 Greater resources would be had, for one, by developing country governments through increased tax revenues. This alone is not sufficient for reducing human deprivation; governments must use these resources well. However some governments deliberately keep certain people poor and deprived, while some governments may use resources ineffectively. So these potential additional resources are a small but nonetheless important part of the solution. Additionally, however, greater resources would accrue to the economy more generally, which could help spur investment and development. As mentioned above, this is thought to be the larger share

It is especially important to take account of such outflows at a time when the international community is questioning the effectiveness and sustainability of traditional sources of development finance, such as ODA, and is looking for new and innovative sources of financing for development. In this vein, a lot of emphasis is being placed on domestic resource mobilization within developing countries themselves as the most sustainable way of financing their development and helping to ease aid dependency.[14] However, the loss of resources through illicit financial flows, including forgone tax revenue and lost investment capital for the local economy, can undermine this goal.[15]

The next two sections describe two of the most important elements of the problem of tax avoidance: corporate profit shifting and financial secrecy.

i. *Corporate profit shifting*

MNCs, corporations with subsidiary companies registered in more than one country, have a variety of strategies available to them for minimizing their tax burden, but the basic idea behind these is to move capital amongst their affiliates in different jurisdictions so that taxable income is reported in places where it is taxed at lower rates and expenses where they are relieved at higher rates. This practice, known as corporate profit shifting, usually involves associating more profits with legal constructs and intangibles such as intellectual property, while reducing the share of profits associated with substantive operations.[16] In other words, it results in fewer profits associated with, and therefore fewer taxes collected by, the source countries where much of the economic activity actually takes place.

A major instance of corporate profit shifting is the practice of abusive transfer pricing. Cross-border transactions (of goods, services and intangibles) between subsidiaries of the same company are not subject to normal market forces; they are governed instead by a process known as transfer pricing. The current standard for MNCs to find an appropriate

of resources currently lost to illicit financial flows, and so is the potentially larger gain to be had by curbing them. Thanks to Thomas Pogge for this point.

[14] Eurodad, "Exposing the lost billions: how financial transparency on a country by country basis can aid development." Eurodad, November 2011. 3. (Available here.)

[15] It is important to note that some countries with the worst problems of illicit financial flows are also doing really well in the global economy, so there is no hard and fast connection between illicit financial flows and low levels of development. Thanks to Gail Hurley for this point.

[16] OECD, *Addressing Base Erosion and Profit Shifting*. OECD Publishing, 2013. 45. (Available here.)

transfer price is the OECD's "arm's-length principle" (ALP).[17] The idea behind the ALP is that the price allocated to an intra-group transaction should reflect the price that would be paid between two different companies on the open market. However, subsidiaries in different countries often charge each other non-APL rates. Abusive transfer pricing schemes include, for example, assigning large values to intellectual property and branding rights or assigning debts to a particular branch of the company so that it can be offset against the profit there. Again, the goal is to minimize income in higher-tax jurisdictions and so reduce the company's overall tax burden.[18] The following example, from a case study carried out by the British organization ActionAid UK, will help to illustrate this phenomenon.

SABMiller is one of the biggest companies in the beer industry. It owns over 200 brands, is the second biggest brewer in the world and the biggest brewer in Africa, owning numerous beer companies there. Many of the 'local' beer brands that SABMiller sells in Africa are owned by other subsidiary companies in the Netherlands, which has a lower tax rate. African subsidiaries pay millions in royalties to the Dutch subsidiaries for the use of these brands. A large part of the profits, then, are officially made in the Netherlands, rather than in the African countries where the beer is produced and consumed. The tax loss to African countries is an estimated £10 million per year.[19]

MNCs are able to minimize their tax burden in these ways, sometimes even succeeding in paying no income tax anywhere at all ("double non-taxation"), by taking advantage of the current system of corporate tax structures. According to the OECD, this kind of strategic

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[17] The arm's length principle: "[When] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." Chapter 1, paragraph 1 of Article 9 of the OECD Model Tax Convention. Quoted in David McNair, Rebecca Dottey and Alex Cobham, "Transfer pricing and the taxing rights of developing countries." Christian Aid, November 2010. 3. (Available here.)

[18] James S. Henry, *The Price of Offshore Revisited.* Tax Justice Network, July 2012. 20. (Available here.)

[19] Action Aid, "The SABMiller guide to tax-dodging." (Available here.) (For the full report, see Action Aid, "Calling Time," available here.) Recall that the tax loss is only part of the problem; there is also the loss of investment capital for the local economy. Suppose that the corporate tax rate in the various African countries where SABMiller operates is 20% and the tax rate in the Netherlands is 5%. Then SABMiller shifts £50 million from its African subsidiaries to its subsidiary in the Netherlands in order to reduce its tax liability by 15% (£7.5 million). The tax revenue loss to the African countries is £10 million (they won't receive the 20% on the £50 million in forgone profit) but the various African economies will also lose a combined £40 million of potential investment capital.

tax planning, or 'tax arbitrage,' is made possible by loopholes resulting from the lack of coordination among different domestic tax rules:

> The interaction of withholding tax rules in one country, the territorial taxation system in another country, and the entity characterisation rules in a third country may combine to make it possible for certain transactions to occur in a way that gives rise to no current tax and have the effect of shifting income to a jurisdiction where, for various reasons, no tax is imposed. Often it is not any particular country's tax rule that creates the opportunity for [profit shifting], but rather the way the rules of several countries interact.[20]

However, according to tax expert Lee Sheppard, corporate tax avoidance is made possible by specific provisions included in bilateral OECD tax treaties: "OECD model treaties give the MNCs' home countries primary tax jurisdiction over income earned by MNCs in source…countries. That is, these treaties require source countries to agree to be deprived of legitimate tax jurisdiction over the income earned within."[21]

Either way these practices are types of tax avoidance, which, as opposed to tax evasion, is not technically illegal. However, it is problematic for several reasons. Firstly, according to the OECD's analysis, "the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy."[22] Secondly, however, even if corporate tax planning *is* the intended result of domestic policy, for example, of certain provisions in OECD bilateral tax treaties, developing countries—which usually have less bargaining power—may sometimes have little choice but to sign such treaties. This background should make us at least question the legitimacy of tax avoidance, despite its legality. Further, tax avoidance by MNCs means that the tax burden on the remainder of the population, via income tax and taxation of small and medium enterprises (SMEs), is higher in order to compensate, which exacerbates inequalities. Finally, tax avoidance hurts the developing world by undermining domestic resource mobilization, and the additional resources that governments would have as a result of reduced tax avoidance could help contribute to a dramatic reduction in human deprivation.[23]

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[20] OECD, *Addressing Base Erosion and Profit Shifting.* 45.
[21] Correspondence, December 9, 2013. According to Sheppard, treaty provisions that substantially limit source countries' tax jurisdiction include separate company accounting, arm's-length transfer pricing, and permanent establishment. Some of these will be discussed below.
[22] OECD, *Addressing Base Erosion and Profit Shifting.* 45.
[23] Although again, greater resources are not sufficient for reducing human deprivation. See footnote 12 above.

An example of tax evasion, in contrast, is trade misinvoicing where corporations reduce their tax burden by deliberately misreporting items—price, weight, quantity—on an invoice submitted to customs.[24] For example, companies will agree to a false price—deflated export prices, inflated import prices—so as to report lower overall profits and consequently minimize their tax burdens.[25] This can occur both between subsidiaries of the same company or between different companies. The practice of misinvoicing is thought to be widespread. UK charity Christian Aid reports that "about 45 to 50 per cent of trade transactions in Latin America are falsely priced by an average of more than 10 per cent; while 60 per cent of trade transactions in Africa are mispriced by an average of more than 11 per cent."[26]

Trade misinvoicing and abusive transfer pricing are some of the greatest contributors to illicit financial flows. GFI estimates that corporate tax abuse accounts for 80% of all illicit financial flows,[27] while for LDCs they account for 65-70% of all illicit flows, according to UNDP.[28] In terms of lost resources, Christian Aid estimates that developing countries lose $160 billion in tax revenues per year due to corporate tax abuse—a total loss of $2.5 trillion for the MDG years (2000-2015).[29] More specifically, they estimate that between 2005 and 2007 Sub-Saharan Africa lost $27 billion through trade misinvoicing, with lost tax revenues of approximately $4.34 billion, while Latin America lost $95 billion through trade misinvoicing, with lost tax revenues of $31 billion.[30] These lost resources have the potential to make a huge difference in the lives of the global poor; for example, Christian Aid estimates that if the tax revenue lost to illicit financial flows were available and allocated according to current spending patterns, the increased health care expenditures alone would save the lives of 350,000 children under five every year.[31] And this impressive figure does not even take into account proportional increases in other potentially life-saving expenditures, such as nutrition, child-care programs, etc, which could improve and save many additional

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24 Trade misinvoicing can also serve other purposes and is not always tax motivated. See GFI, "Trade Misinvoicing."
25 Peter Reuter, "Introduction and Overview: the Dynamics of Illicit Flows" in *Draining Development?* ed. Peter Reuter. The World Bank, 2012. 13.
26 Christian Aid, "Death and taxes: the true toll of tax dodging." Christian Aid, May 2008. 6. (Available here.)
27 Dev Kar and Brian LeBlanc, iii..
28 UNDP, 11.
29 Christian Aid, "False profits: robbing the poor to keep the rich tax-free." Christian Aid, March 2009. 3. (Available here.)
30 Cited in Eurodad, 11.
31 Christian Aid, "False profits," 3.

lives.

ii. *Financial secrecy*

Where does the money lost to misinvoicing and transfer pricing schemes flow to? Certain jurisdictions, which tend to specialize as financial centers, have specific types of regulations that attract illicit capital and help to facilitate illicit financial flows. These include low tax-rates for non-residents, lax regulation, and financial secrecy.[32] Some of these regulations are particularly useful to international corporations, including exemption from the obligation to audit, exemption from the obligation to preserve accounting documentation, exemption from the obligation to hold board meetings locally, and the right to redomicile the company.[33] Arguably of greatest importance, however, is the lack of any legal requirement to register and publish beneficial ownership.[34] Because of this, secrecy jurisdictions are an ideal place to incorporate anonymous trusts and "shell" companies where illicit money can reside untaxed or minimally taxed, with no means of identifying whose money it is.[35]

MNCs use these financial structures to transfer profits abroad to low-tax jurisdictions in order to reduce their tax burden, for example, through the transfer pricing and misinvoicing schemes discussed above. The addition of secrecy regulations "make[s] uncovering the true nature of transactions and tracing beneficial ownership and the origin of the funds difficult for investigators."[36] In addition to corporate tax abuse, however, secrecy jurisdictions also facilitate illicit flows more generally; for example, they enable fraud, bribery, illegal gambling, money laundering and trafficking of contraband goods and services.[37] According to a Global Witness report, of 213 cases of corruption between 1980 and 2010 reviewed by the World Bank, over 70% relied on anonymous shell companies, which are made possible by the kinds

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[32] Norwegian Government Commission on Capital Flight from Poor Countries, "Tax Havens and Development," June 18, 2009. 20. (Available here.) The Commission notes that low tax rates are not necessarily in themselves problematic, but have harmful effects on other countries when combined with these other features. It is also important to note that not all secrecy jurisdictions are alike and can have in place different sets of regulations that attract different types of capital (both licit and illicit) for different reasons. Thanks to Gail Hurley for this point.

[33] Ibid, 35.

[34] The beneficial owner is the person who ultimately benefits financially from the company or assets in question. In trusts, the beneficial owner is separate from the person who has legal control over the company or assets (the trustee).

[35] For more information, see the Tax Justice Network, "In trusts we trust," July 2009. (Available here.)

[36] Global Financial Integrity, "Beneficial Ownership." (Available here.)

[37] James S. Henry, 24.

of financial services offered by secrecy jurisdictions.[38]

The Norwegian Commission details numerous reasons why secrecy jurisdictions are harmful: they increase the risk premium in international financial markets, they increase the inequitable distribution of tax revenues, they reduce the efficiency of resource allocation, they make economic crime more profitable, and they damage institutional quality and growth in developing countries.[39] Finally, secrecy jurisdictions undermine tax systems. As the Commission explains, secrecy jurisdictions attract capital that should have been taxed in other countries, which forces those countries to lower their taxes on capital. This can result either in a decline in revenue, or else in higher tax rates imposed on a narrower base, which reduces tax efficiency and weakens economic growth, especially in developing countries.[40]

Research on the scope of wealth in secrecy jurisdictions is limited, and specific estimates on the proportion of illicit financial flows from developing countries and the proportion of global illicit financial flows that go to tax havens are not publically available.[41] However, what research there is suggests that secrecy jurisdictions house huge amounts of capital that is going untaxed or is only minimally taxed, and which is depriving all countries of much needed tax revenue. The Tax Justice Network estimates that the global total of accumulated financial wealth in secrecy jurisdictions as of 2010 is between $21 and $32 trillion.[42] (It is important to point out, however, that this includes private (in addition to corporate) wealth, for which there can be reasons other than tax evasion and avoidance for investing in secrecy jurisdictions, especially for individuals in the developing world where banking and financial systems are less reliable and where kidnapping may be a problem.[43])

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[38] Global Witness, "Anonymous Companies," May 2013. 2. (Available here.)
[39] Norwegian Government Commission, 11-13.
[40] Ibid, 11-12.
[41] This data is available at the Bank for International Settlements but Bank rules prohibit the data from being released to researchers in a format that allows for further analysis. Thanks to Tom Cardamone for this point.
[42] James S. Henry, 5.
[43] It is estimated that more than 25% of Latin American and 33% of Middle Eastern and African private wealth is invested in secrecy jurisdictions, compared with only about 2% of North American private wealth and 8% of European wealth. (See Stephen B. Cohen, "Does Switzerland's Tax Haven for Offshore Accounts Violate Internationally Recognized Human Rights?" Georgetown, 2013. 2. (Available here.) But for individuals in the developing world, putting private wealth offshore may have motivations other than avoiding taxes: e.g. high inflation, unstable currency, better interest overseas, etc. Thanks to Gail Hurley for this point.

It is estimated that the capital outflows lost to secrecy jurisdictions, and the future earnings associated with those investments, almost entirely offset ODA and foreign direct investment for some developing countries.[44] Moreover, the African Economic Outlook for 2012 reports that missing capital from these outflows deprived the continent of investment opportunities that could have had a huge social impact: "If all capital flight from Africa in 2008 had been invested in MDG-related projects, it could have covered 55% to 68% of the additional resources needed that year to close the financing gap to achieve the targets of halving poverty; reaching gender equality as well the education and health-related goals."[45] Considerations like these highlight the importance of reducing these flows. The next section reviews measures currently in place or under discussion by the international community to address illicit trade-related flows.

II. Current measures to reform rules and practices that facilitate illicit financial flows

The problems that illicit financial flows create for all countries—including by hindering domestic resource mobilization—are now recognized by the international community and policy makers. At the level of the United Nations, illicit financial flows were mentioned in the Monterrey Consensus (2002), the Doha Declaration (2008), the United Nations Summit on MDGs (2010), and the United Nations Conference on Sustainable Development (2012).[46] Last year, the report of the UN Secretary-General's High Level Panel of Eminent Persons on the Post-2015 Development Agenda emphasized the importance of addressing illicit financial flows and curbing revenue lost to tax abuse.[47]

Additionally, the United Nations' Economic Commission for Africa (UNECA) created a High-Level Panel on Illicit Financial Flows form Africa, with a mandate of "promoting better analysis and understanding of the nature and dimensions of illicit financial flows from Africa and assessing its impact on continental development."[48]And within the United Nations Department of Economic and Social Affairs (UNDESA) there is a Committee of

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44 James S. Henry, 7; Norwegian Government Commission, 13.

45 African Development Bank (AfDB), OECD, UNDP and the United Nations Economic Commission for Africa (UNECA), "African Economic Outlook 2012." 21. (Available here.)

46 For the last of these, see §266 of UN, "The Future we Want: Outcome document of the United Nations Conference on Sustainable Development, Rio de Janeiro, Brazil, 20-22 June 2012." (Available here.)

47 High-level Panel of Eminent Persons on the Post-2015 Development Agenda, "A new global partnership: eradicate poverty and transform economies through sustainable development." 2013. (Available here.)

48 UNECA, "High-Level Panel on Illicit Financial Flows from Africa." (Available here.)

Experts on International Cooperation in Tax Matters that works to promote international cooperation among tax authorities and also makes recommendations on capacity-building and technical assistance to developing countries on matters of tax. It developed the United Nations Model Double Taxation Convention between Developed and Developing Countries and, in May 2013, released its *Practical Manual on Transfer Pricing for Developing Countries*.

Following the financial crisis, there has been legislation in the U.S. directed at curbing illicit financial flows. The Foreign Accounts Tax Compliance Act (FATCA) was passed by Congress in 2010 and came into force on January 1, 2013. Its goal is to catch American tax evaders with offshore accounts. Moreover, "Other governments are beginning to enact similar legislation to comply with and extend FATCA's requirements—including between some countries in Europe, as well as between the UK and its crown dependencies in the Channel Islands and some of its overseas territories in the Caribbean."[49] Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which became law in 2010, includes rules under section 1504 promoting transparency in the extractives sector by requiring extractive companies to report their payments to governments around the world.

The European Union has also developed new transparency requirements for companies in the extractive industries under the Accounting and Transparency Directive, while Canada recently announced that it plans to create new reporting rules for extractive companies, which is significant as Canada is the world's leading domicile for mining companies.[50] Lastly, on extractives, the Extractive Industries Transparency Initiative—a global coalition of governments, companies and civil society working together on a voluntary basis to improve transparency in the extractives sector—has begun a pilot project on beneficial ownership disclosure. According to the EITI, "twelve EITI countries…have signed up to the pilot and will disclose the identity of the real owners behind the extractive companies operating in their countries."[51]

[49] International Bar Association's Human Rights Institute Task Force on Illicit Financial Flows, Poverty and Human Rights, "Tax Abuses, Poverty and Human Rights," International Bar Association, 2013. 12. (Available here.)
[50] Ibid, 142.
[51] EITI, "Pilot project: Beneficial ownership." (Available here.)

Within the G8 and G20, tax abuse has been a prominent issue over the last few years. UK Prime Minister David Cameron made the issues of hidden beneficial ownership and financial transparency a priority during the UK's 2013 G8 presidency.[52] The G8's Loch Erne Communiqué from 2013 includes numerous commitments in these areas:

- ensure that domestic and international tax rules do not allow MNCs to reduce their tax burden through profit shifting (§24);
- support the OECD in developing common accounting standards—specifically, country-by-country reporting—for MNCs in order to enhance transparency (§25);
- support and implement OECD efforts on multilateral automatic exchange of information, ensuring that these processes are accessible to developing countries (§26);
- support OECD efforts with respect to improving the quality and availability of transfer pricing information for developing countries (§29); and
- implement the Financial Action Task Force (FATF)'s standards requiring that companies provide information on their beneficial ownership, and to support the implementation of these standards globally (§31).[53]

The G20 also took on the issue of tax abuse in their 2013 meeting in St. Petersburg. The Communiqué states that, "Tax avoidance, harmful practices and aggressive tax planning have to be tackled."[54] It commits the G20 leaders to working with the OECD to tackle profit shifting (§18), increase transparency through automatic exchange of information (§19), and address beneficial ownership by implementing FATF standards (§20).

The OECD is another forum that has been active in addressing illicit financial flows. The Financial Action Task Force (FATF), created by the G7 (within the OECD) in 1989 to combat money laundering, expanded its scope in 1998 to facilitate "increased transparency and strengthened arrangements for information exchange between national authorities."[55] The FATF's mandate was originally set to expire in 2012, but was extended until 2020.[56]

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[52] Global Witness, 2; 9.
[53] Communiqué, G8 Leaders, Lough Erne, June 2013. (Available here.)
[54] Communiqué, Meeting of Finance Ministers and Central Bank Governors, Moscow, 19-20 July 2013. §18 (Available here.)
[55] FATF, 'Ministers renew the mandate of the Financial Action Task Force until 2020' (20 April 2012). (Available here.)
[56] Ibid.

FATF recommendations are currently the standard for best practices on disclosure of beneficial ownership.

Additionally, as a result of a call from the G20 in 2009, the OECD restructured the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) in order to increase transparency and strengthen exchange of information between countries. It was mandated to put in place a peer review mechanism for all Global Forum members to evaluate their exchange of tax information systems. According to the Global Forum, these peer reviews will happen in two phases: "Phase 1 is a review of each jurisdiction's legal and regulatory framework for transparency and the exchange of information for tax purposes and Phase 2 involves a survey of the practical implementation of the standards."[57] Reporting on its progress, the Global Forum states that since 2009 it has completed 100 peer reviews and issued over 600 recommendations for improvement on transparency and exchange of information, more than 300 of which are already being acted upon.[58]

In 2011 the OECD also updated and expanded its Convention on Mutual Administrative Assistance in Tax Matters. The Convention "provides for a multilateral basis to counter international tax evasion and avoidance providing for a wide variety of administrative assistance, including information exchange on request, automatic information exchange, participation in tax examinations abroad, simultaneous tax examinations, joint audits and assistance in the collection of tax debts."[59] The Global Forum reports that since it began its work in 2009, more than 50 countries have signed the Convention or have committed to doing so, and the number of Exchange of Information agreements (both bilateral and multilateral) has increased by around 1,100.[60]

Finally, in addition to its work on transparency and exchange of information, the OECD has also been working on the issue of corporate profit shifting, or Base Erosion and Profit Shifting (BEPS). Its "Action Plan on Base Erosion and Profit Shifting" was released

[57] The Global Forum on Transparency and Exchange of Information for Tax Purposes, "Frequently Asked Questions." (Available here.)
[58] The Global Forum on Transparency and Exchange of Information for Tax Purposes, "Progress Report to the G20 Finance Ministers and Central Bank Governors: Global Forum Update on Effectiveness and Ongoing Monitoring. 5. (Available here.)
[59] Ibid, 35.
[60] Ibid, 7; 35.

earlier this year and presented to the G20 Finance Ministers in July 2013.[61] According to the OECD, the "Action Plan" identifies "15 specific actions needed in order to equip governments with the domestic and international instruments to address this challenge. The plan recognises the importance of addressing the borderless digital economy, and will develop a new set of standards to prevent double non-taxation. This will require closer international cooperation, greater transparency, data and reporting requirements."[62]

Although a lot has happened over the last decade to raise awareness of illicit financial flows in general, and tax abuse and bank secrecy in particular, much more needs to be done. With the MDGs set to expire in 2015, discussions are currently underway to develop a new development framework. This represents a unique opportunity for the international community to take coordinated action on this front. The following section makes recommendations for post-MDG targets aimed at reforming rules and practices relating to illicit financial flows, with the goal of significantly reducing illicit trade-related flows from all countries.

III. Recommendations for goals and targets

<u>Goal</u>: significantly reduce illicit trade-related financial flows.

<u>Targets</u>:

The following are some of the initiatives most discussed and advocated for by tax experts, international organizations and governments concerned with curtailing illicit flows.

i. Reform the arm's-length pricing system

As discussed above, abusive transfer pricing—intra-group transfers at below-market rates—is one of the biggest causes of lost tax revenue for the developing world. In response, numerous experts, including those at the Tax Justice Network, argue for eliminating the ALP system by getting rid of separate company accounting and instead treating all entities of an MNC as a single unit. This would make intra-group transactions irrelevant from the point of

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[61] Ibid, 3.

[62] OECD, Base Erosion and Profit Shifting. (Available here.)

view of income taxation because income would be reported and taxed without reference to how the MNC is organized internally.[63]

Combined reporting and unitary taxation of this sort would require something known as the Global Formulary Apportionment Method (GFAM). As Christian Aid explains, GFAM allocates the global profits of an MNC "on a consolidated basis among the associated enterprises in different countries using a predetermined formula. The formula weights relative activity measures in each tax jurisdiction as follows: the proportion of a multiregional firm's income earned in a given state is expressed as a weighted average of the proportion of the firm's total sales, property and payroll in that state."[64] Despite the merits of this approach, however, many experts point out that getting international consensus on the necessary predetermined formula is extremely unlikely.

A more pragmatic proposal that has also been suggested as a response to the problem of tax abuse through transfer mispricing is to reform the current ALP system so that regard is given to actual economic activity and value creation (substance) rather than just the legal structure of the company (form) for the purposes of identifying the arm's length conditions for intra-group transactions.[65] In theory this would make tax abuse more difficult because MNCs could not rely on their complex web of legal structures to the same extent as under the current ALP system (although a lot depends on the details of the proposal). Moreover, this approach is more politically feasible than the GFAM since it keeps the status quo largely intact.

In addition to these 'substance over form' considerations, the ALP system should also be simplified to make it more accessible for developing countries. The OECD is working on updating and simplifying its Transfer Pricing Guidelines to this end. The OECD has also established a Global Forum on Transfer Pricing in order to facilitate international cooperation on transfer pricing. The UN Committee of Experts on International Tax Matters is also working with the OECD on this issue, and is developing new guidelines for revenue authorities seeking to design and implement tax policies for MNCs.[66] The

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[63] Sol Picciotto, "Towards Unitary Taxation of Transnational Corporations." Tax Justice Network, December 2012. (Available here.)
[64] Christian Aid, "Transfer Pricing," 12.
[65] OECD, *Action Plan on Base Erosion and Profit Shifting.* OECD Publishing, 2013. 14. (Available here.)
[66] Christian Aid, "Transfer Pricing," 11.

international community should seize this current momentum on tax abuse and commit to these reforms in the post-2015 development agenda.

Finally, to help ensure that ALP guidelines are followed once implemented, the Financial Transparency Coalition proposes that "parties conducting a sale of goods or services in a cross-border transaction sign a statement in the commercial invoice certifying that no trade mispricing in an attempt to avoid duties or taxes has taken place and that the transaction is priced using the OECD arms-length principle." [67] This same proposal is made and endorsed by other organizations and experts.[68] A related idea could also be useful for false invoicing; specifically, requiring signatures on commercial invoices from both importers and exporters confirming that "prices accord to world market norms…and contain no element of mispricing for the purpose of manipulating [taxes]."[69] This is a simple and low-cost way to address tax abuse.

ii. Reform international accounting standards: country-by-country reporting

An additional reform measure that would improve the current system of separate company accounting, and is supported by numerous organizations and experts, is country-by-country reporting (CBCR).[70] Currently, corporations are only required to account for trade with unrelated companies and are therefore able to conceal trade between affiliates of the same company. CBCR calls on MNCs to report all sales, profits, and taxes paid in all jurisdictions in their audited annual reports and tax returns—including those belonging to the same parent company—, providing a global picture of an MNC's activities. As a result, CBCR would make profit shifting easily identifiable and would provide some of the data needed for transfer mispricing investigations. There are likely to be two important outcomes: first, CBCR will help deter MNCs from engaging in abusive transfer pricing or other illicit

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[67] Transparency Coalition, "Transfer Pricing.' (Available here.) The Financial Transparency Coalition was formerly the Task Force on Financial Integrity and Economic Development.

[68] See, e.g UNDP, 22; Baker and Joly, 10-11; Christian Aid, "Death and Taxes," 27.

[69] Baker and Joly, 10-11.

[70] CBCR is supported by the UNDP (see UNDP, 4), the European Economic and Monetary Affairs Committee of the EU Parliament and The UN Conference on Trade and Development (see Baker and Joly, 10), Eurodad (see Eurodad, 8), the Task Force on Financial Integrity and Economic Development (see Richard Murphy for the Task Force on Financial Integrity and Economic Development), and the Tax Justice Network (see Richard Murphy for the Tax Justice Network).

forms of profit shifting in the first place,[71] and second, the data needed to resolve disputes in favour of the tax jurisdiction raising a transfer pricing inquiry will be available for the first time.[72]

From a technical point of view, CBCR should be relatively easy to implement since companies already have (or should have, if they are doing proper accounting) the information that it requires, and it is just a matter of disclosure. According to Raymond Baker, "Corporations currently compile these figures for internal control but do not report such information to state regulators. Country-by-country accounting for revenues, costs, and profits is thus of no burden to corporations but hugely beneficial to tax authorities and goes far toward reducing the usefulness of tax havens."[73] Given this, CBCR is a very important item to include on the post-2015 development agenda.

A related area for reform is the International Accountants Standards Board (IASB). This organization is currently privately controlled and comprised of members from the "Big Four" accounting firms (Deloitte, PwC, Ernst & Young, and KPMG) who represent the interests of the financial community. This is problematic as the accounting standards developed by IASB are passed into law in many countries. Christian Aid therefore urges "reform of the International Accounting Standards Board so that it is taken out of private control and given international agency status, and so that it includes members who do not represent the interests of the financial community."[74]

iii. Implement universal automatic exchange of information

A common thread in the discussions on illicit financial flows is the need for greater transparency regarding international financial structures. Automatic exchange of tax information between all jurisdictions is an important goal in this respect. By providing timely, targeted and comprehensive information to tax authorities, automatic exchange of information, like CBCR, will both have deterrent effects with respect to the use of secrecy

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71 Richard Murphy, "Country-by-country reporting: Holding multinational corporations to account wherever they are." Task Force on Financial Integrity and Economic Development, June 2009. 21. (Available here.)

72 Richard Murphy, "Country-by-country reporting: accounting for globalization locally," Tax Justice Network, 2012. 40. (Available here.)

73 Raymond Baker and Eva Joly, "Illicit Money: Can it be Stopped?," *New York Review of Books*, December 3, 2009. (Available here.)

74 Christian Aid, "Death and Taxes," 27.

jurisdictions for tax abuse, and will enable authorities to detect and act upon cases of non-compliance with international standards.[75] Automaticity is important as it can facilitate early detection of tax abuse.[76]

As discussed in section II, there are several initiatives promoting multilateral exchange of information, including recent work by the OECD's Global Forum. Moreover, the G8 stressed the importance of global exchange of information in its Lough Erne Communiqué: "We see recent developments in tax transparency as setting a new standard and commit to developing a single truly global model for multilateral and bilateral automatic tax information exchange building on existing systems. We support the OECD report on the practicalities of implementation of multilateral automatic exchange and will work together with the OECD and in the G20 to implement its recommendations urgently."[77] Automatic exchange of information is also supported by international agencies such as the UN (in its Model Income Tax Treaty) and UNDP, and tax justice organizations such as the Tax Justice Network.[78] The G20 also endorsed automatic exchange of information during the St. Petersburg Summit; they pledged to implement automatic exchange of information among their members by 2015, and called on all jurisdictions to follow suit. The international community should seize this current momentum and commit to *universal* automatic exchange of information in the post-2015 development agenda.

However, some critics worry that the current G20 model of automatic exchange of information will not benefit developing countries as fully as it should.[79] One common criticism, for example, is of the requirement to provide reciprocal data. The problem is that, for some developing countries, this requirement will exceed their current capacities thereby excluding them from full participation in the program, at least in the short term; or that, if they do adopt automatic exchange of information under these conditions, then "overstretched revenue authorities…will have to undergo a massive reprioritisation of efforts towards putting in place systems to enable them to supply information automatically. This when they already struggle to find the capacity for, for example transfer pricing

[75] Global Forum report, 36.
[76] OECD, *Action Plan on Base Erosion and Profit Shifting*. 14.
[77] Communiqué, G8 Leaders, Lough Erne, June 2013. §26
[78] See UNDP, 4; James S. Henry, 44.
[79] For a more complete analysis, see Christian Aid, "Automatic for the people." (Available here.)

audits."[80] A further concern is with the ability of developing countries to use the information received. This will require ensuring that data is accessible, comprehensive, and in a standard format.[81] The OECD has recognized this and they are currently working on creating a standardized model of automatic exchange that is secure and cost-effective.[82] The most general concern, however, is with the exclusion so far of developing countries from the process of setting the rules on automatic information exchange. The post-2015 development agenda is an ideal forum for ensuring that this process is inclusive, and that the needs and concerns of developing countries are met.

iv. Require public registers of beneficial ownership

The ability to hide beneficial ownership is a main facilitator of all types of illicit financial flows, including tax-avoiding and tax-evading flows. A significant step towards addressing these problems would be for jurisdictions to require the disclosure of the natural person(s) who is/are the beneficial owner of a company or assets. The FATF recommendations are the current standards for establishing beneficial ownership; they specify that the identity of the beneficial owner must be available to authorities in an adequate, accurate and timely manner.[83] Global Witness, however, argues stronger requirements are needed. Specifically, "Countries should require companies to put information about their beneficial owner(s) in the public domain, available for free, in open data format, in line with agreed standards."[84] As they argue, it is important that this information be made public, as opposed to only being accessible to law enforcement, so that citizens, journalists and civil society can also hold companies to account.

One possible way of addressing the issue of beneficial ownership along with other elements of financial secrecy is through a Convention on Transparency in International Economic Activity, as has been proposed by the Norwegian Government Commission, with the goal of "prevent[ing] states from developing secrecy structures which are likely to cause

[80] Martin Hearson, "Some heretical thoughts on automatic information exchange and developing countries," April 24, 2013. (Available here.) Also Christian Aid, "Automatic for the people," 5.
[81] Christian Aid, "Automatic for the people," 5.
[82] OECD, "Automatic Exchange of Information." (Available here.)
[83] Global Witness, 6.
[84] Ibid.

loss and damage to other jurisdictions."[85] According to the Commission, the Convention should:

> First…bind states not to introduce legal structures that, together with more specifically defined instruments, are particularly likely to undermine the rule of law in other states. Second, states which suffer loss and damage from such structure must have the right and duty to adopt effective countermeasures which will prevent structures in tax havens from causing loss and damage to public and private interests both within and outside of their own jurisdiction.[86]

This is a very ambitious goal which is likely to face significant political resistance, not least from secrecy jurisdictions themselves who profit from providing this type of financial service, and some of which are located in politically powerful places (e.g. Switzerland, the city of London, the US state of Delaware, etc), while others rely on providing financial secrecy as the primary source of their own development (e.g. the Cayman Islands, the Cook Islands, Mauritius, etc). However, the post-2015 agreement could contain a pledge to work toward such a convention.

v. Increase the rate of stolen asset repatriation

In addition to these preventative and transparency measures meant to curtail future illicit flows, a different type of initiative that has been raised by various organizations, including the UN Office of the High Commissioner for Human Rights (OHCHR) and Christian Aid, is the restorative one of asset repatriation. According to a World Bank report, only about $5 billion of the $300-600 billion, or around 1%, of stolen assets from the last 15 years have been successfully repatriated.[87] Increased political pressure, greater international cooperation and significantly more funding, however, can help repatriation efforts be more effective.[88] Additionally, in 2011 the UN OHCHR released a report making various recommendations to facilitate repatriation of illicit finds.[89] The findings of this report as well as the UN Convention against Corruption could serve as useful models for international efforts to repatriate wealth that is the result of tax evasion.[90] Moreover, the World Bank, in

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85 Norwegian Government Commission, 16.

86 Ibid, 144-5.

87 Kevin M. Stephenson et al, "Barriers to Asset Recovery," World Bank, 2011. 186. (Available here.)

88 Ibid.

89 OHCHR, "Comprehensive study on the negative impact of the non-repatriation of funds of illicit origin to the countries of origin on the enjoyment of human rights, in particular economic, social and cultural rights" (A/HRC/19/42), 14 December 2011. 16-17. (Available here.)

90 Christian Aid makes this same proposal directed specifically at the governments of the UK and Ireland. See Christian Aid, "Death and Taxes," 27.

partnership with the UN Office on Drugs and Crime, already has a repatriation program, the Stolen Asset Recovery (StAR) Initiative, whose efforts should be scaled up and which could serve as an international forum for work on this issue.

vi. Increase ODA for capacity-building in developing countries

These international-level efforts to address tax abuse must be complemented by domestic-level capacity-building efforts in developing countries that are more limited in their ability to respond but that are greatly affected by it. For example, as the African Tax Administration Forum states: "The taxation of international transactions, in particular transfer pricing, has become increasingly difficult. Transfer pricing today typically involves huge and expensive databases and high-level expertise to handle, which developing countries cannot match."[91]

Moreover, several of the international policy initiatives just discussed—country-by-country reporting, automatic exchange of information—will result in making more financial information available to governments. This is a necessary step for reducing tax abuse but is insufficient insofar as some developing countries' technical and administrative capacities are not adequate for both implementing these measures and effectively using the resulting information. International efforts in developing these policies should therefore be complemented by international efforts to help build up the local infrastructure needed to successfully detect illicit behaviour and undertake effective enforcement actions against it. Strengthening the capacities of developing countries in both respects should be a priority for the international community.

On these fronts, a promising initiative is the OECD's proposal for Tax Inspectors Without Borders (TIWB): "The TIWB objective is to facilitate the transfer of tax audit knowledge and skills through a real-time, 'learning by doing' approach. Matched through the TIWB mechanism, tax audit experts would work directly with local officials on current audits concerning international tax issues and to share general audit practices." [92] The feasibility study for TIWB was welcomed in the Lough Erne G8 Leaders Communiqué."[93] In a similar vein, UNDP suggests that developing countries would benefit from "systematic

[91] Quoted in Eurodad, 12.
[92] OECD, "Tax Inspectors without Borders," OECD Publishing, July 2013. 1. (Available here.)
[93] Communiqué, G8 Leaders, Lough Erne, June 2013. §28

customs reform and the adoption of transfer pricing regulations with commensurate increase in enforcement capacity. The implementation of specialised software which helps governments to identify possible incidences of transfer pricing may also be useful to some governments."[94] Finally, the international community should also help build up existing domestic efforts at capacity-building, including institutions like the African Tax Administration Forum (ATAF), and "home-grown" knowledge-sharing platforms, such as the African Union Commission's Africa Platform for Development (APDev).[95]

Lack of capacity is very important dimension of the problem of tax abuse and while OECD research has shown that the return on ODA investment targeted towards capacity building of developing countries' tax administrations is very high, currently only a fraction of ODA is dedicated to this purpose.[96] Development cooperation in this area should be scaled up, and committing a greater portion of ODA towards supporting tax administration in developing countries is a feasible and high-impact way for the post-2015 development agenda to address tax abuse.

These measures, if implemented, would go a long way toward reducing illicit financial flows. ASAP will advocate for the international community to take up these initiatives and commit to seriously curtailing illicit financial flows in the post-2015 development agenda, and beyond.

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[94] UNDP, 3.

[95] Thanks to Michael Sudarkasa for this point. (Correspondence, September 17 and September 20, 2013)

[96] Thanks to Gail Hurley for this point. (Correspondence, September 19, 2013)