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TAX EXPENDITURES LAB

The role of Tax Expenditures in Enabling Illicit Financial Flows

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Overview - structure

- **Introduction**: Tax Expenditures (TE) as enablers of IFFs
  1. IFF "push" and "pull" factors in tax regulation
  2. TEs as IFF drivers in source countries
     - Extractives taxation (contracts, royalties, transfer pricing)
     - Special Economic Zones (SEZ)
     - Tax treaties
  3. TEs as IFF drivers in destination countries
     - Patent Boxes
     - Tonnage tax
     - Luxury SEZ: Freeports
- **Conclusions**

Tax Expenditures (TEs) as enablers of IFF

- Defining tax-related IFFs :

Tax crimes	Tax avoidance	Compliance certainty

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Illicit Financial Flows

- Tax evasion, fraud (concealment, false declaration, artificial structures, complex schemes e.g. Cum-Ex /Cum-Cum, VAT Missing trader etc.)
- Money laundering

UTP, litigation, 5-year record retention period…

Letter & Spirit of the Law

- Legitimate use of TEs furthering transparent policy goals
- Good-faith compliance with regulatory requirements
- Cooperative compliance and tax filing simplification

Tax Expenditures (TEs) as enablers of IFF

- **Tax Expenditure**: preferential tax treatments that deviate from the benchmark or standard tax system and are applied to benefit specific groups, activities or economic sectors – resulting in revenue forgone.

- **Illegal** and potentially **Illicit** uses of TEs:

Clearly illegal | **illicit** | ...

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- Fraudulent claim of TE benefits
- Reinvestment of criminal proceeds through preferential tax regimes (tax-free ML)
- ML of tax-evaded proceeds

- Abuse of TEs (round tripping, treaty shopping, profit-shifting)
- TE can result in weak public control and oversight
- TE proliferation brings complexity & opacity

1. IFF “push” and “pull” factors in tax regulation

➢ Certain tax regulations enable the outflow and/or the inflow of IFFs from/to a jurisdiction (Carbonnier and Mehrotra, 2018), for example:

IFF “push” factors	IFF “pull” factors
Source country	Recipient country
Extractives TEs (contractual, tax holidays, royalties exemptions)	Patent boxes (reduced tax on IP income) and Tonnage tax regimes
Special Economic Zones (SEZ)	Luxury SEZ : Freeports
Secrecy in the source country	Secrecy in the destination country
Bilateral tax treaty and/or investment treaty (if any)	

Illicit financial Flow

2. TEs as IFF drivers in Source countries

Why are these tax regulations in place?

IFF "push" factors
Examples in Source countries
Extractives TEs (contractual, tax holidays, royalties exemptions)
Special Economic Zones (SEZ)
Secrecy in the source country
Bilateral tax treaties

- Economic interests pressure
- Weak administrative capacity
- Legacy treaties/legislation/contracts
- Transparency shortcomings enable corruption

Expected benefits:

- Additional investment (FDI)
- Infrastructure development
- Positive externalities such as employment growth and technology transfers

2. TEs as IFF drivers in Source countries

- **SEZs (Special Economic Zones): Key Features**
  - Wide variation in scale, focus, and regulatory regime (e.g., "zones within zones").
  - Different TEs: Customs duties, VAT, and CIT exemptions (e.g., reduced rates, suspensive regimes).
  - Over 6,000 SEZs globally, including 2,500+ in China (UNCTAD, 2023)
- **Transparency Issues:** SEZs as "black boxes“ - hard to evaluate TEs' effectiveness.
- **Illicit Financial Flows (IFFs):**
  - Trade mis-invoicing and profit shifting (Heitmüller and Mosquera, 2021)
  - SEZs can operate as tax haven jurisdictions for BEPS risks
  - Weak governance enables illicit activities (e.g., ML/TF, environmental crimes).

2. TEs as IFF drivers in Source countries

- **Role of TEs in Extractive Industries**
  - Intended to attract FDI, particularly in resource-rich countries.
  - Tax expenditures (TEs) include: tax holidays, Export Processing Zone (EPZ) benefits (e.g. import duties and/or CIT exemptions), reduced royalty rates, and fiscal stabilization clauses.

- **Challenges**
  - **BEPS Risks:**
    - Use of subsidiaries in low-tax jurisdictions for profit routing.
    - Mispricing, deductible outbound payments (interests, royalties, services)
  - **Stabilization Clauses:**
    - Lock in preferential tax terms, hindering governments' ability to adapt laws.
    - Often opaque and not disclosed for public evaluation (Mosquera Valderrama, 2021)
    - Potentially unfair treatment towards new investors

2. TEs as IFF drivers in Source countries

Cross-Cutting Issues in SEZs and Extractive Industries

- **Tax Treaties and IFFs**
  - Treaties often interact with SEZ and extractive industry regimes, compounding IFF risks (e.g. PE exclusions, WHT limitations)
  - Example: Botswana's treaties with Mauritius and Luxembourg prevent taxation of capital gains derived from land rights - indirect transfers (Hearson, 2023)
- **Governance Challenges**
  - Lack of oversight, transparency, and monitoring in SEZs and extractive industries (FATF, 2021; FATF and Egmont Group, 2013; OECD, 2022)
  - Secretive contracts (e.g., Botswana's diamond mining sector) conceal taxation details, enabling corruption and IFFs.
- **Legal and Dispute Risks**
  - Stabilization clauses and treaty provisions often lead to legal disputes over tax revenues - royalties 12%, capital gains 8% (Baistrocchi and Hearson, 2017)

3. TEs as IFF drivers in Recipient countries

Why are these tax regulations in place?

IFF "pull" factors
Examples in Recipient countries
Patent boxes (reduced tax on IP income) and Tonnage tax regimes
Luxury SEZ : Freeports
Secrecy in the destination country
Bilateral tax treaties

- Weak enforcement/regulation
- Tax competition
- Transparency shortcomings enable corruption and HNWI and MNC concealment

Expected benefits:

- Rents and Intermediation fees
- Financial/logistics hub development
- Positive externalities such as employment growth and R&D
- Provide advantages to resident MNC investing in other countries

3. TEs as IFF drivers in Recipient countries

- **Role of Recipient Countries in IFFs**
  - Absorb financial flows that evade taxation in source countries.
  - Offshore financial centers act as **transit hubs** or **final destinations** for IFFs
  - Common strategies:
    - **Decoupling** income or ownership from its (potentially illegal) source.
    - Use of preferential tax regimes (e.g., CIT holidays, low/no tax).

- **Profit-Based TEs and IFFs**
  - Encourage profit shifting from higher-tax jurisdictions (Meinzer et al., 2019)
  - Examples: territorial CIT regimes, Intellectual Property (IP) boxes.
  - Distinction between:
    - **Profit-Based TEs:** Lower tax rates regardless of effective economic activity. Reduces tax paid in already profitable investments.
    - **Expenditure-Based TEs:** Provisions that reduce tax burden to the extent of additional expenditure (e.g. super-deductions, accelerated depreciation)

3. TEs as IFF drivers in Recipient countries

- **Intellectual Property Boxes (or “patent boxes”)**
  - Aim to attract R&D and innovation by reducing tax rates on IP income, yet…
    - Ineffective in increasing real innovation or R&D (Alstadsæter et al., 2018)
    - Promote patent relocation without shifting actual research activities
    - Lead to mismeasurement of global IP flows (e.g., inflated intangible asset values)
    - Nearly 20 European countries have IP Box regimes
      - Reduced rates ranging from 0% in Malta to 15.5% in France
      - OECD “nexus” approach is insufficient
    - Coupled with tax treaties’ 0% royalty WHT exemption
      => **double non-taxation**

3. TEs as IFF drivers in Recipient countries

- **Tonnage Tax Regimes**
  - Applied to international shipping **based on vessel tonnage**, not profits.
  - Issues: "*the race to the bottom has reached the bottom*" (Maisto, 2017)
    - Effective tax rates as low as 0.5–2%. (Steer, 2022; Rivero, 2022)
    - May apply to extractives activities (e.g., offshore drilling, exploration).
    - Profits booked in jurisdictions where extractives activities are not undertaken… e.g. CYP, DNK, NLD, MLT

- **Luxury SEZ: Freeports**
  - Tax-free storage of High-Value Assets (HVA), e.g. Geneva, LU, SG, NY…
  - Common mis-conception of "extra-territoriality" (ICC, 2020)
    - – Lack of statistics
    - – Poor/no AML enforcement
  - Secrecy: Shell company use / absence of ownership registration (BO)
  - Enables large-scale ML and tax evasion (Helgadottir, 2020)

Conclusions

- **TEs enabling IFFs:**
  - Tax expenditures with direct impact on IFFs are evidenced both in Source and Recipient countries
  - Legacy treaties and legislation may not be adapted to new policy objectives (see Readhead and Taquiri, 2021)
- **Transparency**:
  - Comprehensive public reporting of existing TE regimes and their cost is necessary for evidence-based policy-making
  - Reporting on SEZ statistics should be harmonized globally (e.g. UN COMTRADE)
- **Tax simplification**: multiplication of TEs without monitoring/evaluation capacities brings problematic complexity. Unitary taxation vs. “independent enterprise fiction” (OECD, 2017)
- **Multilateral agreements** have advantages vs. bilateralism (e.g. AEOI, tax collection…)
- **TE design and evaluation**: importance of establishing clear policy objectives and specific monitoring indicators. Climate adaptation/transition dimensions ideally evaluated.

Thank you!

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