Defining trade and tax -related IFFs

UNCTAD

Approach for defining IFFs

- Align with existing practices and statistical frameworks:
  - BoP & SNA work to measure illegal activities and flows
  - Tax gap estimation by tax authorities
  - Customs and international work to review trade misinvoicing
  - New initiatives to identify profit shifting flows etc.

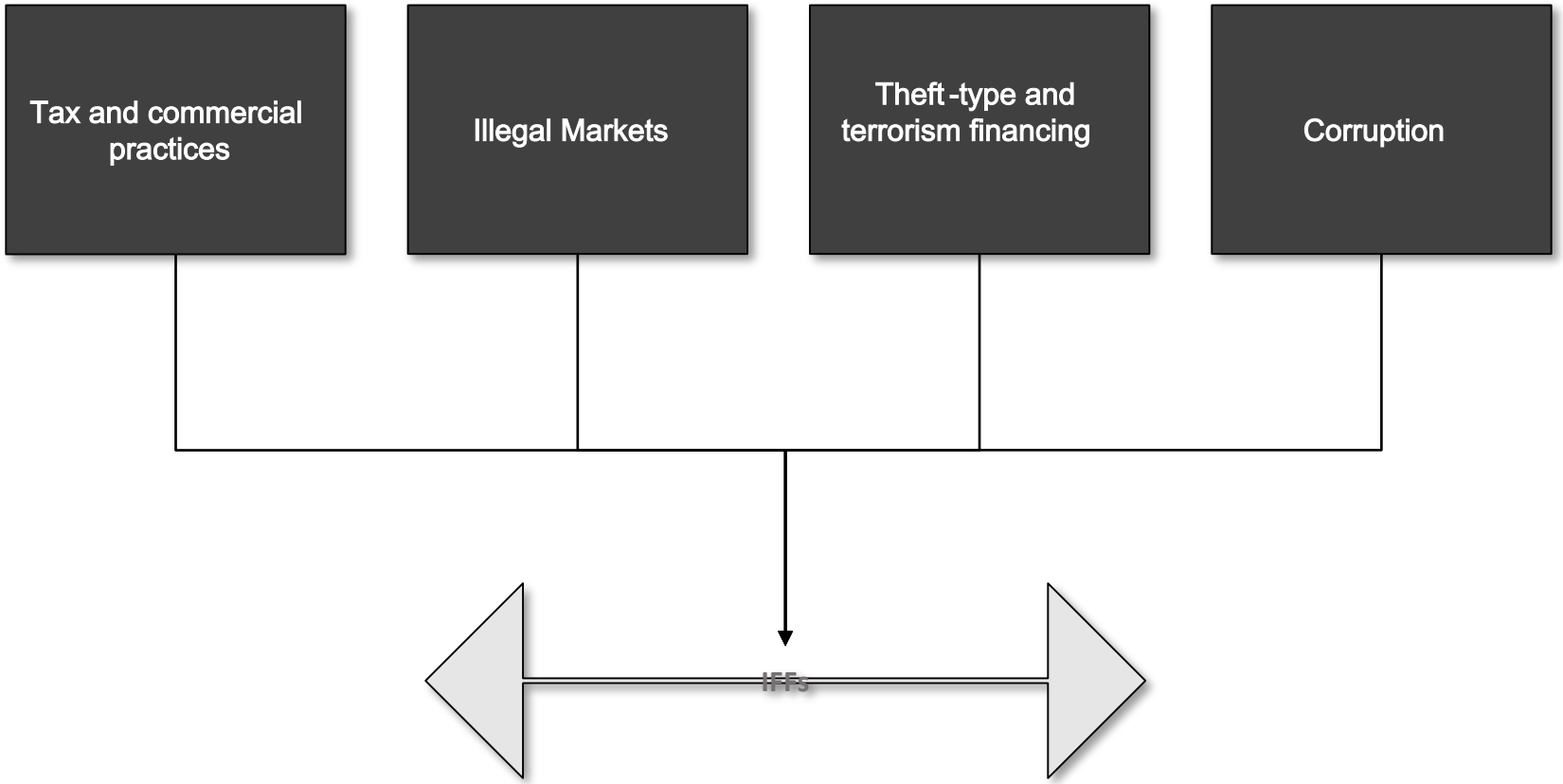
- Aim at comparable statistics across countries
  - Laws and legal practices differ
  - Instead of legality, identify behaviours and events
  - Develop a typology of activities generating IFFs

Typology of IFFs based on statistical classifications

- A typology of IFFs for statistical purposes should be:
  - Exclusive - each IFF classified
  - Exhaustive - include each manifestation of IFFs
  - Feasible - possible to populate with data

- The typology should consider data needs:
  - Policy uses (taxation, international trade, crime etc.)
  - Events and behaviours that generate IFFs (tax evasion, trade mispricing, criminal activities etc.)
  - Sources of IFFs (e.g. drug trafficking, criminal economy, trade etc.)
  - Channels of IFFs (e.g. FDI, IP, trade, intra-MNE flows, etc.)
  - Resulting assets (e.g. offshore wealth, real estate, other etc.)
  - Actors (e.g. individual, business etc.).

Main categories of IFFs



Current estimates of IFFs vary

- GFI (2019): IFFs 20% of developing country trade (in 2006-2015) & US$1.1 tn globally in 2015 (out and inflows)
- Corporate sector:
  - US$12tn or 38% of all FDI positions go through empty corporate shells with no real activity (Damgaard and Elkjaer, 2017 & Damgaard, Elkjaer and Johannesen, 2018)
  - Revenue losses from profit shifting estimated at US$280bn globally in 2012 and 30% of US CIT (Clausing, 2016).
  - A company typically saves in corporate inversion US$45mn in CIT, reducing their ratio of worldwide tax to earnings from 29% to 18%. (CBO, 2017)
- Individuals hold US$7tn (equivalent to 10% of global GDP) – in tax havens (Alstadsæter, Johannesen and Zucman, 2018)
- Regionally, HLG-IFFs (2015) estimates IFFs from Africa at US$50 bn annually, roughly equivalent to ODA to Africa. About 65% of IFFs estimated to be generated by commercial activities, criminal 30% and corruption 5%

UNCTAD (2015) studies on MNEs

- MNEs contribute US$730bn annually to government budgets in developing countries, of which, corporate income taxes account for some US$220bn
- These contributions represent on average, 10% of total government revenues, around 5 percent in developed countries. In Africa, the share is 14 percent
- Estimated US$100bn annual tax revenue losses for developing countries related to inward investment stocks directly linked to offshore hubs
- Some 30% of cross-border corporate investment stocks – FDI and investments SPEs routed through offshore hubs
- A 10% increase in the use of ‘offshore hubs’ for inward investment associated with a 1% decline in taxable income
- Exposure of developing economies is still on the rise.

Individual cases may be large

- Following 'Paradise Papers' Statistics Netherlands was able to estimate new financial flows related to intellectual property rights within MNEs (de Haan and Haynes, 2018)

- In one case only, in 2016, Google's Dutch subsidiary paid almost €15bn to its Bermudan subsidiary (2.4 times Bermuda's total GDP in that year), which were not included in the national accounts of that territory

Starting with what exists

- The International Classification of Crime for Statistical Purposes (UNODC, 2015) includes the below IFF generating activities
  - A starting point for developing a typology of IFFs
  - Includes trade misinvoicing, tariff, tax, duty and revenue offences…
  - To be complemented with other IFFs related to tax and trade

	Examples
Tax and commercial practices	08041 Tariff, taxation, duty and revenue offences 08042 Corporate offences including competition and import/export offences; acts against trade regulations 08045 Market manipulation or insider trading, price fixing
Theft-type activities and terrorism financing (parts of sections 02, 04, 09)	020221 Kidnapping 020222 Illegal restraint 020223 Hijacking 020229 Other deprivation of liberty 0204 Trafficking in persons 0205 Coercion

Other IFFs related to trade and taxes

- There are large flows related to profit shifting that relocate financial assets and affect tax bases
- These include licit and illicit flows artificially reducing the effective tax rate of MNEs compared to similar domestic firms
- “Artificial financial flows” could potentially be defined as financial flows related to a disconnection of the location of profits and the real activity generating them.
- Empirically difficult to separate between illegal (tax evasion) and illicit practices (tax avoidance)
- The related behaviours and events include different types of profit shifting and tax planning schemes benefitting from loopholes in tax systems or from preferential tax treatment.
- The intra-firm arrangements are typically complex and can utilise several channels in combination
- More information on the size and channels is needed for policy

Channels of profit shifting –examples

- Profit shifting refers to MNEs reducing their corporate income tax (CIT) burden e.g. by locating profit generated in higher-tax rate countries to lower-tax rate countries (see OECD, 2016)
- Types of activities considered as profit shifting, include:
  - **Transfer price optimisation:** Optimising the price of transactions between related entities within the range of market-based so-called "arm's-length" prices to achieve tax advantages.
  - **Strategic location of intangibles, assets and risks:** Allocating through intra-group arrangements the ownership of intangibles, assets and risks in low-tax countries to divert profit from high-tax countries. Operational functions are more difficult to relocate. Thus, the value-creating activities using those intangibles stay in higher-tax locations under contract to the legal owner.
  - **Debt shifting:** Country differences in corporate income tax rates create opportunities for lending from low-tax countries to affiliates in high-tax countries or for locating external borrowing in high-tax countries (interest payments deductible from income). (IMF, 2018)

Offshore structuring –examples

- **Headquarter relocation** - decisions relate to tax and/or other strategic considerations. High tax rates and high employment rates seen as push factors for headquarter relocation (Laamanen et al., 2012).

- **Corporate inversions** - a special case of cross-border mergers and acquisitions (M&As) influenced by tax considerations – a way for MNEs avoid repatriation of taxes:
  - Corporate inversions can take the form of a merger with a foreign entity, which then results in the former domestic parent becoming a subsidiary of the new foreign parent even though the shareholders retain more than 50% of the shares in the new corporation. (IMF, 2018)
  - Taxation is a major driver for cross-border M&As (Huizinga, Voget and Wagner, 2009).

Tax treaty shopping as a source of financial flows

- **Double taxation treaties** (DTTs) (over 3000) create opportunities for treaty shopping: payments are diverted through a country with the lowest withholding tax (WHT) (e.g. via a Special Purpose Entity).
- For **hybrid instruments and transfers** tax treatment differs, e.g. convertible bonds seen as debt or as equity (interest deduction in the first case and tax-exempt dividend in the second).
- **Hybrid entities (partnership/corporation)** can be treated differently in two countries for tax purposes, even as tax resident by no country ("stateless entities").
- For **preferential tax treatment** MNEs may shift certain incomes to another country to benefit from special tax treatment, e.g. patents.
- **Negotiated tax rates** may be agreed between an individual MNE and the tax authority of a country.
- **Tax deferral** by retaining foreign earnings abroad (residence tax is imposed only upon repatriation of profit). Tax deferral affects the present value of taxes paid instead of the total, and the timing of flows.

Discussion

Where to start?

By end of 2019

1. Agree SCOPE – comprehensive vs. operational
2. Agree DEFINITIONS and CLASSIFICATIONS (terminology)
3. Possible DATA SOURCES
4. Alignment with BoP and SNA (other?)
5. Propose methodologies for statistical authorities

Discussion (cont)

1. Do you think a typology of behaviours and activities generating IFFs is a good starting point?
2. Does your institution focus on the channels, sources or impacts of IFFs?
3. How to find a balance between an operational definition and a comprehensive definition?
4. What data and statistics could be useful in measuring s.o. “artificial financial flows”?
5. How can we deal with double counting when different measurement approaches?
6. What else do we need to consider?