

## INVESTMENT FLOWS THROUGH OFFSHORE FINANCIAL HUBS DECLINED BUT REMAIN AT HIGH LEVEL

**EMBARGO**  
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### HIGHLIGHTS

- *In 2015, the volatility of investment flows to offshore financial hubs – including those to offshore financial centers and special purpose entities (SPEs) – rose significantly. These flows, which are excluded from UNCTAD’s FDI statistics, declined but remain sizable.*
- *Financial flows through SPEs surged in volume during 2015. The magnitude of quarterly flows through SPEs, in terms of absolute value, rose sharply compared with 2014, reaching the levels registered in 2012-2013. Pronounced volatility, with flows swinging from large-scale net investment in the first three quarters to drastic net divestment in the last quarter, tempered the annual result, which dipped to US\$221 billion.*
- *Investment flows to offshore financial centres continued to retreat from its recent high of US\$132 billion in 2013, but remained roughly in line with the flows of previous years. Investment to these jurisdictions, which hit an estimated US\$72 billion in 2015, had risen in recent years by the growing flows from multinational enterprises (MNEs) located in developing and transition economies, sometimes in the form of investment round-tripping.*
- *The proportion of investment income booked in low tax, often offshore, jurisdictions is high – and possibly growing. The disconnect between the locations of income generation and productive investment results in substantial fiscal losses, and is therefore a key concern for policy makers.*
- *The persistence of financial flows routed through offshore financial mechanisms highlights the pressing need to create greater coherence among tax and investment policies at the global level. The international investment and tax policy regimes are both the object of separate reform process. Better managing their interaction would not only help to avoid conflict between the regimes but would also make them mutually supporting, with positive implications for productive cross-border investment.*

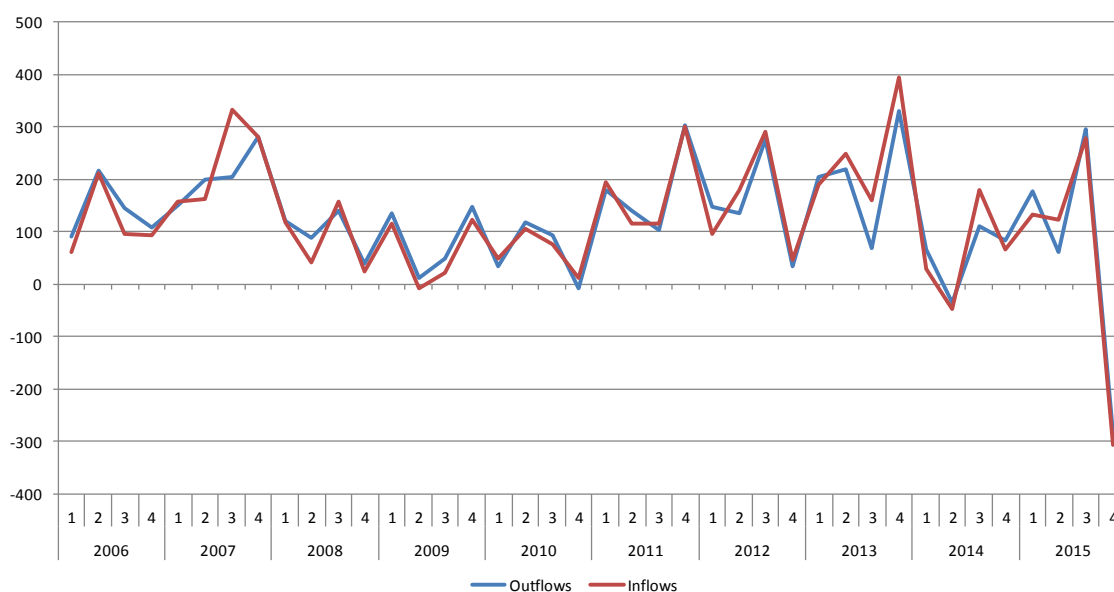
The volatility of investment flows to offshore financial hubs – including those to offshore financial centers and special purpose entities (SPEs<sup>1</sup>) – increased in 2015. These flows – which UNCTAD excludes from its FDI data – nevertheless remain significant.

Offshore financial hubs offer low tax rates or beneficial fiscal treatment of cross-border financial transactions, extensive bilateral investment and double taxation treaty networks, and access to international financial markets, which make them attractive to companies large and small. Flows through these hubs are frequently associated with intra-firm financial operations – including the raising of capital in international markets – as well as holding activities, including of intangible assets such as brands and patents.

### *Investment flows through SPEs surged in volume in 2015*

Investment flows to SPEs, which represent the majority of offshore investment flows, registered significant volatility in 2015. Financial flows through SPEs nonetheless surged in volume during much of the year. The magnitude of quarterly flows through SPEs, in terms of absolute value, rose sharply compared with 2014, reaching the levels registered in 2012-2013. Pronounced volatility, with flows swinging from large-scale net investment during the first three quarters to a huge net divestment during the last quarter, tempered the annual 2015 results (figure 1).


**Figure 1. Investment flows to and from SPEs: 2006.Q1-2015.Q4**  
(Billions of US dollars)



Source: ©UNCTAD.

Note: SPEs include all countries that publish SPE data.

<sup>1</sup> While there is no specific definition of an SPE, they are characterized by little or no real connection to the economy in which they are resident, but serve an important role within an MNE's web of affiliates by holding assets or liabilities, or by raising capital.



The primary recipient of SPE-related investment flows in 2015 was Luxembourg. Flows to SPEs located in Luxembourg were associated with funds financing investments in the United States. This was especially apparent in the first quarter of the year, when SPE inflows rose to US\$129 billion. SPE outflows in the same quarter reached US\$155 billion, which in turn was reflected in data from the United States, where inward FDI from Luxembourg topped US\$153 billion (77% of total inflows). After surging for three quarters, more than tripling their 2014 levels for the same period, SPE inflows turned negative in the last three months of the year, recording a net divestment of roughly US\$115 billion, as SPEs in the country paid down intra-company loans to the tune of US\$207 billion.

After registering a sharp decline in 2014, SPE-related inflows in the Netherlands initially showed signs of a rebound in 2015, rising from US\$2 billion in the first quarter to US\$148 billion in the third quarter (their highest quarterly level since 2007Q3). As in Luxembourg, these flows retreated sharply in the fourth quarter, with a net divestment of equity capital and reinvested earnings of roughly US\$200 billion. An analysis of the geographical breakdown of total investment flows suggests that this trend was driven by investors from Luxembourg and the United Kingdom. Reflecting the pass-through nature of these flows, outward investment flows by SPEs also tumbled in the fourth quarter, led by dramatic declines in overall investments targeting Luxembourg and the United Kingdom. The tight interrelation between SPE flows in Luxembourg and the Netherlands highlights the existence of dense and complex networks of these entities in both countries, with capital flowing rapidly among them in response to financing needs and tax planning considerations.

Recent policy changes may be responsible for the most recent decline in investment flows to SPEs. The Netherlands, for instance, adopted new substance requirements for group financing and licensing companies; these requirements also allowed for the automatic exchange of information about entities with little or no substance in the country with tax treaty partners and other EU countries. In Luxembourg, the authorities enacted a number of changes in their tax framework, including greater substance requirements, a revision of transfer pricing rules, and a reform of the process and substance of tax rulings. Additionally, in late 2015 both countries enacted general anti abuse rules (GAAR), as required by the amended EU Parent Subsidiary Directive (PSD), which seeks to eliminate abuse of the benefits of the PSD for purposes of obtaining a tax advantage.<sup>2</sup> Due to the volatile nature of offshore financial flows, the actual impact of these policy changes will become clearer over the next few years.

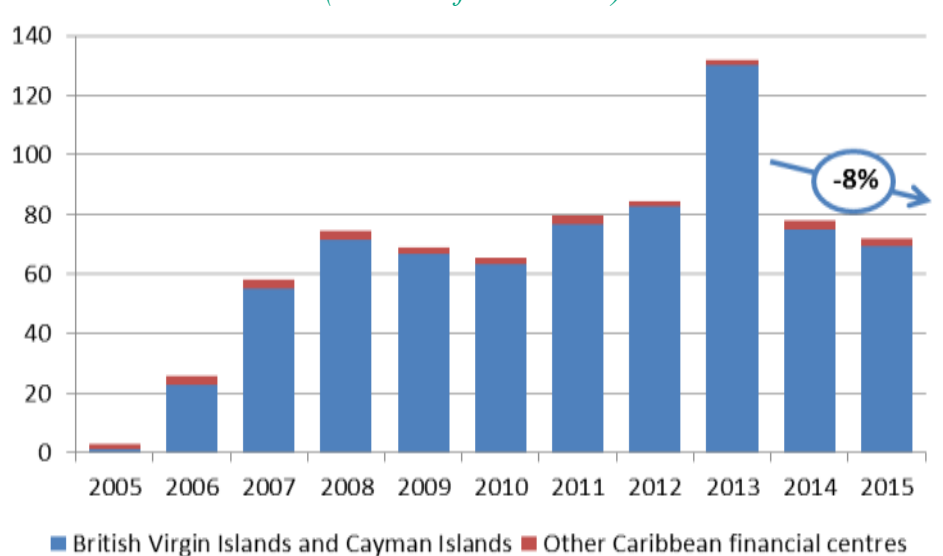
### *Investment flows to Caribbean financial centers slowed, but remain at high level in some OFCs*

Investment flows to Caribbean offshore financial centers continued to decline from their 2013 record levels, when a single large cross-border M&A caused them to surge markedly. Compared with that year, inflows in these economies were down 42% to an estimated average of US\$75 billion in 2014-2015 (figure 2). Nevertheless, this is in line with their 2008-2012 period average of US\$75 billion, due to the high level of flows to two major OFCs.

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<sup>2</sup> Council Directive (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

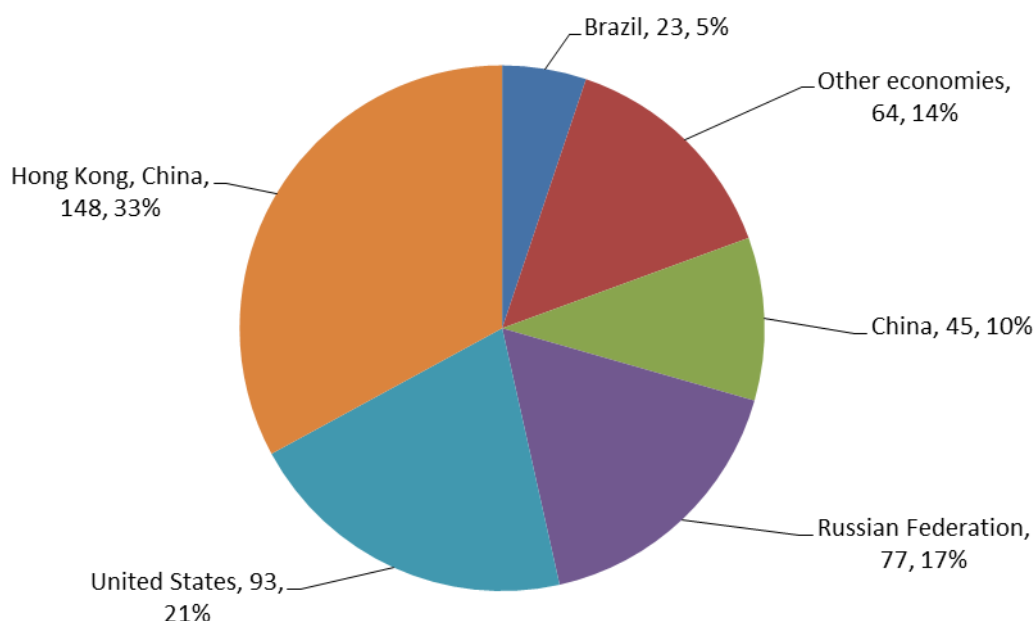
**Figure 2. Investment flows to Caribbean offshore financial centers, 2005-2015**  
(Billions of US dollars)



Source: ©UNCTAD.

While MNEs from developed economies, in particular from the United States, traditionally dominated flows to these jurisdictions, in recent years rising investment flows from developing and transition economies has played an important role. Between 2010 and 2014, Hong Kong (China), the Russian Federation, China and Brazil accounted for 65% of investment flows to the largest Caribbean financial centers, the British Virgin Islands and the Cayman Islands (figure 3).

**Figure 3. Geographical origin of investment flows to British Virgin Islands and Cayman Islands: sum of 2010-2014 values**  
(In billions of US dollars and percentages)



Source: ©UNCTAD.

## High concentration of FDI income in low tax, often offshore, jurisdictions

A key concern for policymakers globally is the potential for a substantial disconnect between productive investments and income generation by MNEs with implications for sustainable development in their economies. As the *World Investment Report 2015* revealed, losses due to MNE's tax practices are sizable. The significant share of MNE's total FDI income booked in low tax, often offshore, jurisdictions remain therefore problematic.

Ratios of income attributed to foreign affiliates of outward investing countries to the gross domestic product (GDP) of the economy where those affiliates are resident reveal profits that are out of line with economic fundamentals. For example, MNEs from a sample of 26 developed countries registered more profits in Bermuda (US\$43.7 billion) than in China (US\$36.4 billion) in 2014 (table 1). Unsurprisingly, the share of their profits relative to the size of Bermuda's economy is an impressive 779.4% of GDP, compared to less than 1% of GDP in a number of countries. Elevated FDI income to GDP ratios can also be observed in other countries. For example, the FDI income of foreign affiliates (as reported by their home countries) in the Netherlands, Luxembourg, Ireland and Singapore relative to their GDPs all exceed the weighted world average by a substantial margin.

**Table 1. Income booked in foreign affiliates: 2014<sup>a</sup>**  
(Billions of US dollars)

Partner economy	Outward FDI income (26 countries)		
	Value	Share of total	Relative to GDP
Netherlands	154.6	12.3	17.6
United States	114.1	9.1	0.7
United Kingdom	97.9	7.8	3.3
Luxembourg	74.2	5.9	114.4
Switzerland	62.3	5.0	8.9
Ireland	61.1	4.9	24.3
Singapore	57.3	4.6	18.6
Bermuda	43.7	3.5	779.4
Canada	40.9	3.3	2.3
China	36.4	2.9	0.3
Germany	32.4	2.6	0.8
Brazil	31.6	2.5	1.3
Cayman Islands	30.4	2.4	874.9
Belgium	26.0	2.1	4.9
Australia	24.3	1.9	1.7
Hong Kong, China	23.4	1.9	8.0
Spain	20.8	1.7	1.5
Japan	18.2	1.4	0.4
Russian Federation	17.8	1.4	1.0
France	17.2	1.4	0.6
Sweden	15.4	1.2	2.7
Mexico	15.2	1.2	1.2
Norway	13.2	1.0	2.6
Qatar	12.5	1.0	5.9
Austria	12.1	1.0	2.8
<i>Memorandum</i>			
208 jurisdictions	1 257.6	100.0	1.6

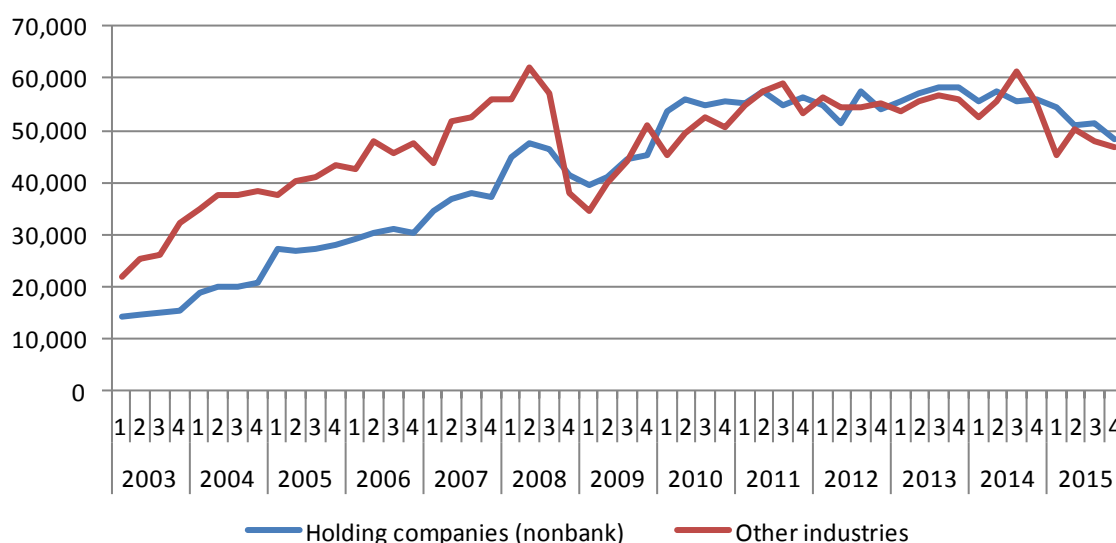
Source: ©UNCTAD, based on data from OECD.Stat and UNSD.

<sup>a</sup> Includes income generated from SPE and non-SPE FDI stock. Data refers to outward FDI income of Australia, Belgium, Canada, Czech Republic, Denmark, Estonia, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Luxembourg, Netherlands, New Zealand, Norway, Poland, Slovak Republic, Slovenia, Spain, Sweden, United Kingdom and the United States.

High FDI income to GDP ratios reflects the emergence of holding companies as major aggregators of MNE's foreign profits. In the case of Bermuda, the outsized profits of foreign affiliates in the country largely reflect income attributed to investors from the United States. According to statistics from the United States, the majority of the outward direct investment position in Bermuda is in holding companies, who likely serve to channel investment to other countries as well as aggregate income – in line with the controlled foreign corporation (CFC) rules of the income tax code of the United States – from these investments for tax purposes.

Taking a longer term view, data from the United States highlights a significant shift in the sources of overall FDI income since the global economic and financial crisis (figure 4). Prior to the crisis, most FDI income was generated from entities other than holding companies, the latter accounting for an average 40% of total quarterly income between 2003 and 2008. In the aftermath of the crisis, however, the share of FDI income attributed to holdings companies has steadily risen to a quarterly average of 52% in 2015. The growing importance of holding companies is due to a number of factors, including the greater reliance on regional centers to coordinate activities in host countries, but their frequent location in jurisdictions with low tax rates or favorable fiscal regimes suggests that tax motivations play a key role.

**Figure 4. FDI Income on outward investment of the United States, 2003.Q1-2015.Q4**  
(Millions of US dollars)



Source: ©UNCTAD, based on data from the United States Bureau of Economic Analysis (BEA).

This shift towards holding companies as the principal aggregators of earnings has also increased the geographical concentration of where FDI income is ultimately booked. The six countries that each accounted for 5% or more of the United States' outward FDI stock in holding companies in 2014 – Bermuda, Ireland, Luxembourg, Netherlands, United Kingdom, United Kingdom Islands (Caribbean) – generated an average 40% of FDI outward income between 2005 and 2008. In 2015, this share had risen to a quarterly average of 59%, an increase of nearly 20 percentage points in the span of less than a decade.



## *The urgent need for international tax and investment policy coordination*

Efforts to stem offshore financial flows have been underway both at the national and international levels. Besides the policy reforms in the Netherlands and Luxemburg mentioned above, and the European Commission anti-tax avoidance package, the United States has been gradually implementing the *Foreign Account Tax Compliance Act* (FATCA), which largely classifies as foreign financial institutions (FFIs) affiliates of non-financial MNEs from the United States that are involved in group financing or holdings, triggering new compliance obligations. There has also been momentum towards tighter international cooperation in tax affairs, such as the G20/OECD BEPS initiative launched in 2013.

Revelations that firms large and small have been using offshore financial centers and jurisdictions to evade or avoid taxes have provided additional impetus to policy reforms in these areas. More efforts are indeed necessary, and the persistence of investment flows routed through offshore finance centers, as well as the level of profits booked in these jurisdictions, highlight the pressing need to create greater coherence among tax and investment policies at the global level. A lack of coordination between these two crucial policy areas will limit positive spillovers from one to the other, limiting potential gains in tax compliance as well as productive investment.

The international investment and tax policy regimes are closely interrelated. Both have the same ultimate objective: promoting and facilitating cross-border investment. They have a similar architecture, made up of a “spaghetti bowl” of mostly bilateral agreements. The two systems face similar challenges, such as, for example, strengthening their sustainable development dimension and maintaining their legitimacy. They interact, with potential consequences in both directions; and both are the object of reform efforts.

These reforms must maintain the effectiveness of both policy regimes to sustain confidence in, and support for, both. The policy imperative is to continue facilitating cross-border productive investment and taking action against tax avoidance to support domestic resource mobilization for the pursuit of sustainable development.

Each regime will have its own reform priorities, related to its specific area of competence. But there is merit in greater coherence between the two reform processes, with better-managed interaction to not only avoid conflict between the regimes (e.g. by carving out taxation from BITs) but also make them mutually supporting.

Ensuring that international tax and investment policies are mutually reinforcing is fundamental to building and maintaining an enabling environment for investment, maximizing the chances of securing financing for development targets, and supporting the integration of developing countries in the global economy.

In the *World Investment Report 2015*, UNCTAD proposed a set of guidelines for coherent international tax and investment policies that could help realize the synergies between investment policy and initiatives to counter tax avoidance. Key objectives include removing aggressive tax planning opportunities as investment promotion levers; considering the potential impact of anti-avoidance measures on investment; taking a partnership approach in recognition of shared responsibilities between host, home and conduit countries; managing the interaction between international investment and tax agreements; and strengthening the role of both investment and fiscal revenues in sustainable development, as well as the capabilities of developing countries to address tax avoidance issues.



## HIGHLIGHTS

### UNCTAD'S GLOBAL INVESTMENT TREND MONITOR

(Issued in January 2016)

- *Global FDI flows jumped 36% in 2015 to an estimated US\$1.7 trillion, their highest level since the global economic and financial crisis of 2008-2009.*
- *A surge in FDI targeting developed economies (+90%) was the principal factor behind the global rebound. Strong growth in flows was reported in the European Union (EU) as well as in the United States where FDI quadrupled, although from a historically low level in 2014. As a result, the pattern of FDI by economic grouping tilted in favor of developed countries which now account for 55% of global FDI inflows in 2015.*
- *However, the growth was largely due to cross-border merger and acquisitions (M&As), with only a limited contribution from greenfield investment projects in productive assets. Moreover, a part of FDI flows was related to corporate reconfigurations involving large values in the financial account of the balance of payments but little movement in actual resources.*
- *Developing economies saw their FDI reaching a new high of US\$741 billion, 5% higher than in 2014. Developing Asia, with its FDI flows surpassing half a trillion US dollars, remained the largest FDI recipient region in the world, accounting for one third of global FDI flows. Flows faltered in Africa and Latin America and the Caribbean (excluding offshore financial centers) reflecting the plummeting prices of their principal commodities exports*
- *Flows to transition economies continued to fall (-54%) as tumbling international commodities prices and regional conflicts undercut FDI. Investment in the region's two largest host economies, the Russian Federation and Kazakhstan, fell sharply.*
- *Cross-border M&As increased by 61% in 2015, while the overall value of announced greenfield investment projects registered little change from the previous year. There was a decline in announced greenfield investments in developing economies, pointing to a growing weakness in MNEs' capital expenditures.*
- *Barring another wave of M&A deals and corporate reconfigurations, FDI flows are expected to decline in 2016, reflecting the fragility of the global economy, volatility of global financial markets, weak aggregate demand and a significant deceleration in some large emerging market economies. Elevated geopolitical risks and regional tensions could further amplify these economic challenges*





**For the latest FDI trends please see above the highlights from the UNCTAD's Global Investment Trend issued in January 2016**

**An in-depth analysis of FDI trends will feature in the forthcoming World Investment Report 2016, to be published in 21 June 2016.**

For the latest investment trends and policy developments, please visit the website of the UNCTAD's Division on Investment and Enterprise  
**[www.unctad.org/diae](http://www.unctad.org/diae)**

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