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International Tax and Investment Policy Coherence

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INTRODUCTION: THE TAX AND INVESTMENT POLICY IMPERATIVE

Intense debate and concrete policy work is ongoing in the international community on the fiscal contribution of multinational enterprises (MNEs). The focus is predominantly on tax avoidance – notably in the base erosion and profit shifting (BEPS) project. At the same time, sustained investment is needed in global economic growth and development, especially in light of financing needs for the Sustainable Development Goals (SDGs). The policy imperative is, and should be, to take action against tax avoidance to support domestic resource mobilization and to continue to facilitate productive investment.

The fiscal contribution of MNEs, or the avoidance thereof, has been at the centre of attention for some time. Numerous instances of well-known firms paying little or no taxes in some jurisdictions despite obviously significant business interests have led to public protests, consumer action and intense regulatory scrutiny. Action groups and non-governmental organizations (NGOs) have brought to light cases of abusive fiscal practices of MNEs in some of the poorest developing countries. Broad support in the international community for action against tax avoidance by MNEs has led to a G20 initiative to counter BEPS, led by the Organization for Economic Co-operation and Development (OECD), which is the main (and mainstream) policy action in the international tax arena at the moment.

The formulation of the post-2015 development agenda and the financing needs associated with the SDGs have added to the spotlight on the fiscal contribution of MNEs as an important source of revenue for governments and a crucial element of resource mobilization for sustainable development. Financing the future development agenda will inevitably have to address the eroding tax base of all countries and especially developing countries. MNE tax avoidance is a real challenge. At the same time, the SDG formulation process has also highlighted the need for increased private sector investment. The *World Investment Report 2014 (WIR14)* showed how in developing countries public investment will be insufficient to cover an estimated \$2.5 trillion annual investment gap in productive capacity, infrastructure, agriculture, services, renewables and other sectors. New private investment not only contributes directly

towards progress on the SDGs, but also adds to economic growth and the future tax base.

The key question is thus: how can policymakers take action against tax avoidance to ensure that MNEs pay “the right amount of tax, at the right time, and in the right place” without resorting to measures that might have a negative impact on investment? In other words, how can they maximize immediate tax revenues from international investment while maintaining a sufficiently attractive investment climate to protect the existing and future tax base? If sustainable development requires both public and private investment, the fiscal climate for investors must be balanced for local and foreign companies alike to ensure sufficient *revenues* to support public investment and sufficient *returns* to promote private investment. This is especially pertinent for structurally weak economies and the least developed countries (LDCs), where public investment needs for basic development purposes are often more acute.

The links between cross-border investment¹ and tax policy go in both directions:

- Tax has become a key *investment determinant* influencing the attractiveness of a location or an economy for international investors (box V.1).
- Taxation, tax relief and other *fiscal incentives* have become a key policy tool to attract investors and promote investments.
- Investors, once established, add to economic activity and the tax base of host economies and make a direct and indirect *fiscal contribution*.
- International investors and MNEs, by the nature of their international operations, as well as their human and financial resources, have particular opportunities for tax arbitrage between jurisdictions and *tax avoidance*.

The focus of this chapter is on the latter two links, on the fiscal contribution of MNEs and the extent to which they engage in tax avoidance, as these are at the core of the debate in the international community today. However, any policy action aimed at increasing fiscal contribution and reducing tax avoidance, including the policy actions resulting from the BEPS project, will also

Box V.1.

Tax as a determinant of FDI: what role does tax play in location decisions?

Conventional wisdom has it that tax does not play a fundamental role in investment location decisions. Multinationals make their decisions to enter a particular market mostly on the basis of economic determinants – e.g. the size and growth of a market, access to resources or strategic assets, and the cost of factors of production. Moreover, a host of non-tax policy determinants are generally considered more relevant for location decisions, such as the stability and predictability of the business climate, the strength of commercial law and contract enforcement, trade restrictions, the intellectual property (IP) regime, and many others.

In this view, tax does not so much drive locational decisions as it drives the modality of the investment and the routing of investment flows. Top managers of MNEs decide to enter a given market largely independent of tax considerations, and their tax advisers then structure the investment in the most tax-efficient manner. The fact that a significant share of global investment is routed to its final destination through special purpose entities (SPEs) and tax havens, discussed later in this chapter, lends credence to this view.

The relevance of tax in investment decisions is generally considered low for resource- and strategic asset-seeking investments and for market-seeking investments, and only one of many determinants driving location decisions for efficiency-seeking investments. However, a number of nuances require consideration.

- *Resource-seeking investments* can be highly capital intensive and have very long gestation periods. Calculations of expected returns can be extremely sensitive to cost factors, of which tax is an important one. Investments tend to be subject to long and arduous negotiations over precisely how rents are distributed between investors and states, and through what fiscal mechanisms. The fact that negotiators on both sides make trade-offs between different levying mechanisms (e.g. taxes versus royalties) should not be mistaken for a lack of attention to any one of them. Moreover, stability and predictability in the fiscal treatment of these investments are crucial, given their long-term nature and long payback periods.
- *Market-seeking investments* per se may appear to be less sensitive to tax. But the modus operandi of investors can be strongly influenced by tax. The extent to which MNEs source and produce locally or rely on imported value added, key to the development impact of foreign investments on host economies, is clearly influenced by tax. The common view that market-seeking investments are less sensitive to tax tends to confuse the market-entry decision with actual investment in productive capacity.
- *Efficiency-seeking investments*, through which MNEs look for low-cost locations for parts of their production process, are highly sensitive to tax. Counter-intuitively, for many of these investments low tax rates do not actually feature high on the list of locational determinants that MNEs consider, because the expected rate is exceedingly low. Due to the nature of these investments, they tend to be located in special economic zones or fall under special regimes. The differentials across locations in labour costs and productivity, availability and cost of land and other factors of production, and trading costs, tend to be far more important than tax rate differentials at such low levels. However, it is the tax base that is really of interest to investors in efficiency-seeking operations, as these are often steps in the global value chains of MNEs, and transfer pricing plays a prominent role. In addition, low taxes on international transactions are obviously a key determinant. Without special regimes, economies are often at a disadvantage for efficiency-seeking investments, confirming the fact that tax can be a key locational determinant.

Thus the importance of tax as a locational determinant risks being generally underestimated. The growth of global value chains, which has increased the relative weight of efficiency-seeking investments in the mix, has served only to make tax an even more important factor in countries' attractiveness and this trend is likely to continue.

It is not only the *level* of taxation that matters in investment decisions. It is also the ease with which tax obligations can be fulfilled that is important. Indicators of the ease of doing business – covering a range of administrative procedures relevant to business operations, including paying taxes – generally feature prominently in location comparisons presented to investors. UNCTAD's Business Facilitation programme, which helps developing countries simplify administrative procedures for investors, prioritizes procedures for paying taxes immediately after procedures for business registration and licensing.

Most important is the stability and predictability of the fiscal environment in host countries. A perceived risk of significant changes in the fiscal regime or in the fiscal treatment of individual investments will tend to be a showstopper. Fiscal authorities that demonstrate the capacity to establish collaborative relationships with investors and provide confidence as to the continuing fiscal treatment of investment operations can help remove a major obstacle to investment.

In summary, tax plays an important role in location decisions, principally in three ways: the fiscal burden, the administrative burden, and long-term stability and predictability.

Source: UNCTAD.

have to bear in mind the first and most important link: that of tax as a determinant of investment.

In addition, in the debate on the public revenue contributions of MNEs, fiscal incentives for investors are also often considered a form of “leakage” or “slippage” of tax revenues for governments, much like tax avoidance schemes (although they are clearly different in that they represent a deliberate policy measure to attract investment). Critical questions have also arisen as to whether MNEs are making adequate contributions for the extraction or exploitation of natural resources. Some of these issues feature in the BEPS discussion where policy action is relevant, for example, to avoid allowing incentives to become part of the tax avoidance toolkit of MNEs, leading them to shift profits to locations with tax holidays. Concerns have been raised about the ability of MNEs to play governments and locations against each other, inducing a “race to the bottom” in tax levies. Incentives and tax avoidance have other parallels – tolerance by authorities of “aggressive” tax minimization schemes can be seen as a (less transparent) alternative to explicitly provided incentives. Nevertheless, this chapter will not attempt to add to the vast body of existing analysis on fiscal incentives and their relative ineffectiveness, but rather focus on key knowledge gaps in the ongoing international debate:

- How much do MNE foreign affiliates contribute to government revenues, especially in developing countries? What is the value at stake, or the baseline, for policy action against tax avoidance?
- How do patterns of international investment flows and stocks drive MNE tax contributions as well as tax avoidance opportunities, and what is the impact on fiscal revenues for developing countries?
- On balance, what is the net fiscal contribution of MNE activity and what are the implications for the links between tax and investment policy, especially in the context of anti-avoidance policy action and BEPS?

As such, the chapter helps lay the foundation for a discussion on harmful tax competition.

The chapter is structured as follows:

Section A looks at the contribution of MNEs to government revenues, especially in developing countries, taking a broad approach including fiscal contributions through corporate income tax as well as other taxes, social contributions and other revenue sources including, critically, royalties on natural resources.

Section B provides the key analytical results on the magnitude and patterns of international corporate investments through offshore investment hubs. It presents an innovative perspective on indirect or transit investment patterns in the global economy – the *Offshore Investment Matrix* – and shows the extent to which investment and tax considerations are inextricably intertwined. The section also describes the root causes behind the outsized role of offshore hubs in global investment and reviews the most relevant MNE tax planning schemes. It specifically highlights those schemes that are most dependent on offshore structures and therefore most visible in global investment patterns.

Section C focuses on the development impact of tax avoidance schemes and estimates the related tax revenue losses for developing economies. It provides estimates that can be considered complementary to existing efforts in the international community, but derived from a new approach based on the *Offshore Investment Matrix*.

Section D draws policy conclusions from taking an investment perspective on MNE tax planning practices and brings them together in a set of guidelines for Coherent International Tax and Investment Policies.

The annexes to this chapter (available online) provide the detailed methodology and approach for the two key analytical contributions: the fiscal contribution of MNEs and the investment perspective on international tax avoidance (including the *Offshore Investment Matrix* and the tax revenue loss calculations). The two technical annexes respond to demand in the international community for new ideas and methods to examine the fiscal impact of MNEs – including an explicit call in the G20 BEPS Action Plan. A third non-technical annex provides an overview of existing countermeasures to tackle tax avoidance and an account of the ongoing debate in the international community.

A. MNEs AS A SOURCE OF GOVERNMENT REVENUES FOR DEVELOPMENT

Policymakers and experts at work on the BEPS project have so far not arrived at a quantification of the value at stake for government revenues. Various research institutes and NGOs have put forward estimates for the amount of taxes avoided by MNEs in developing economies. To date, there is no estimate of a baseline establishing the actual contribution of firms in general and MNEs in particular.

To measure the value at stake at the intersection between international tax and investment policy, and to set a baseline for any discussion on tax avoidance by MNEs, this section examines the overall contribution of foreign affiliates of MNEs to government revenues.

In order to understand the context within which MNEs pay taxes, social contributions, and other levies and fees, the section first provides a broad picture and breakdown of government revenues overall and looks at differences in revenue collection between economies at various levels of development. This initial examination of overall government revenues is instrumental to the approach to estimating MNE contributions developed in this chapter. The approach zooms in from overall government revenues to overall corporate contributions (domestic and foreign), and finally to foreign affiliate contributions. Such an approach ensures that margins of error in estimations are confined along the way. Nevertheless, as available data on foreign operations and tax payments of MNEs are limited and fragmented, the analytical approach has been heuristic, employing a variety of sources and methods to converge towards a meaningful *order of magnitude* for MNE contributions. Annex I describes in detail the data approach and analytical steps.

Looking at the broader backdrop for foreign affiliate contributions to government revenues makes clear that some characteristics of revenue collection in developing economies that might at first glance appear to be a function primarily of the fiscal behaviour of investors are in fact often due largely to structural features of the economy. This is important in the context of the ongoing Financing for Development debate, in which improving domestic resource mobilization is a key pillar under plans to fund progress towards the SDGs. Policy actions focusing on the tax contribution of foreign investors can be an effective way to increase

government revenues but must be seen as part of a broader programme of action addressing domestic resource mobilization.

At the same time, UNCTAD's estimates show that the fiscal impact of MNE foreign affiliates in developing countries is sizable and that their contributions represent an important part of total government revenues. These findings support the need for a balanced approach, through appropriate measures that preserve the financing pool provided by foreign affiliates while at the same time tackling tax avoidance.

It is important to note that the approach taken here assesses not only the pure tax contribution of foreign affiliates (corporate income as well as other taxes) but also other contributions to government revenues, including royalties on natural resources, as well as the corporate share of all other forms of government revenues, in order to provide a full picture of the value at stake. In all cases, data are transparent and clearly distinguish actual tax from other types of contributions.

Finally, the aim in this section is not to arrive at a value *judgement* on the fiscal contribution of MNEs (i.e. whether it is “enough”, which is for each government to decide), but only at a rough but objective value *measurement*, as a baseline for the subsequent discussion of tax avoidance.

1. Government revenues and revenue collection in developing countries

In the context of the Financing for Development debate, in which improving domestic resource mobilization is a key pillar under plans to fund progress towards the SDGs, it is important to point out that the level of economic development is generally a more significant driver of variations in revenue collection than natural resource endowment or the presence of MNEs. As a general rule, the lower the level of development of a country, the higher is the share of corporates in government revenue generation and the greater the importance of non-tax revenue streams contributed by firms, including royalties on natural resources, tariffs and other levies.

There are large variations in government revenue collection between countries and regions. Looking at

government revenues as a share of GDP, a key driver for such variations is the level of income of economies (figure V.1). High-income countries collect, on average, about 40 per cent of GDP in taxes, social contributions and other revenues, low-income countries less than 20 per cent.

Looking at economic groupings and regions reveals a mixed picture because of large variations between countries within each region. The weighted average ratio of government revenues to GDP of developing countries is still more than 10 percentage points lower than that of developed countries. The 30 per cent of GDP collected in Africa, which compares favourably with the developing-country average of 27 per cent, is skewed by a few upper-middle-income countries with above-average revenues (mostly due to income from natural resources) that make up for much lower collection ratios in a large group of low-income countries. The lowest levels of revenue collection as a share of GDP are found among the LDCs in Asia.

Overall, the level of economic development and related issues of governance and high degrees of informality are generally more significant drivers of variations in total revenue collection than natural resource endowment or the presence of MNEs. Figure V.2, which focuses specifically on Africa, shows that at

given levels of per capita income, especially at lower income levels, the availability of natural resources and the penetration of FDI do not substantially change revenue collection as a share of GDP.

The composition of government revenues (figure V.3) reveals further insights.²

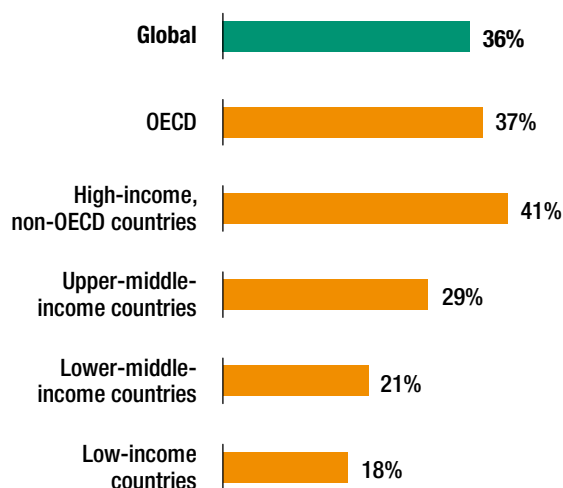
- i. At the first level of disaggregation (left-hand chart in figure V.3), splitting total revenues by taxes, social contributions and other revenues (which include, among others, royalties on natural resources and official development assistance or grants), developed countries show a larger proportion of revenues in the form of social contributions, on average. Developing countries unsurprisingly rely to a much greater extent on other revenues – mostly income from natural resources. The poorest countries tend to rely most on such other revenues: they make up almost half of government revenues in LDCs and in the African region as a whole. There is a clear pattern of shifting revenues from (corporate) income taxation to other revenues related to natural resource endowment. In Africa, at a given level of revenue collection (30 per cent of GDP), resource-driven countries (those with commodity exports representing more than 75 per cent of total exports) exhibit a revenue distribution heavily

Figure V.1.

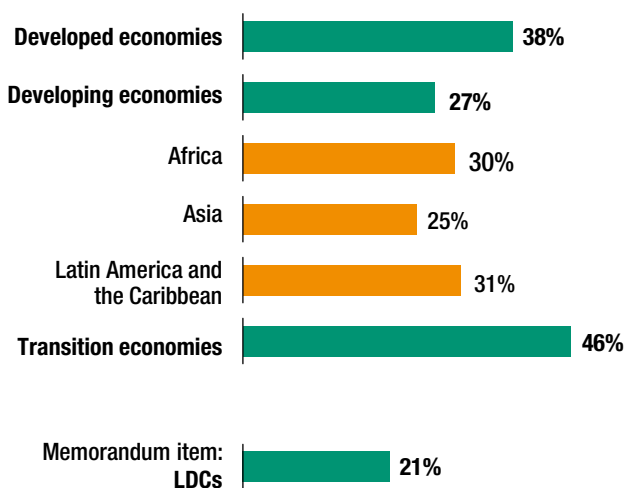
Differences in government revenue collection

Government revenues as a share of GDP, weighted averages (Per cent)

By income level



By region



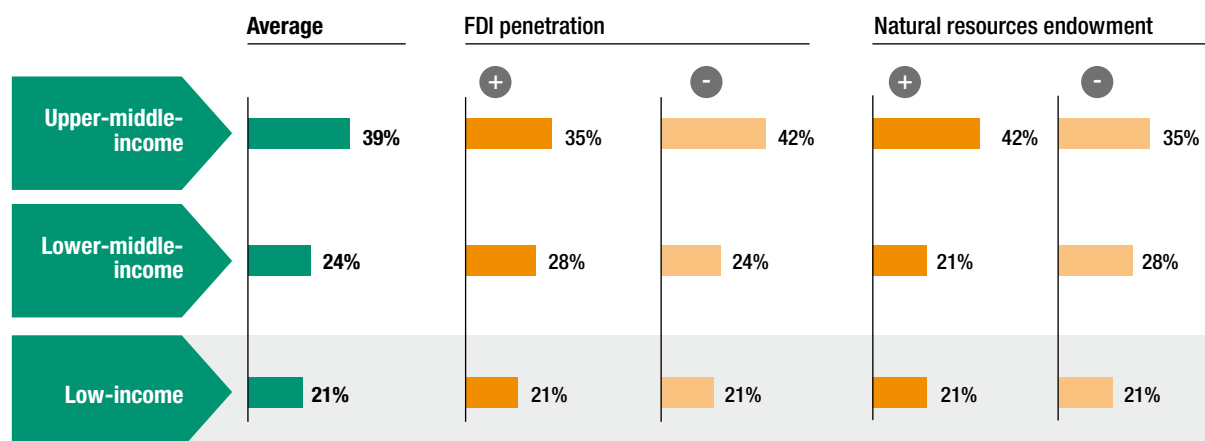
Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset (release September 2014, reference year 2009).

Note: Full details on data sources and methods provided in annex I.

Figure V.2.

Relationship between FDI penetration, resource endowments and government revenues

Government revenues as a share of GDP, weighted averages, Africa (Per cent)



Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset.

Note: For FDI penetration, for each income-level group of countries, "+" is assigned to countries ranking in the top half in terms of the ratio of FDI stock over GDP. For natural resources, "+" is assigned to countries in which the share of commodities in total exports is greater than 75 per cent.

skewed towards other revenues (at about 60 per cent of total revenues), while income taxes account for less than 15 per cent; by contrast, the group of non-resource-driven countries shows income taxes at almost 40 per cent of total revenues and other revenues at 25 per cent. Resource-rich lower-income countries may be making a trade-off in tax collection from corporates between royalties (and export revenues) on the one hand, and corporate income taxes on the other.

- ii. Breaking down the revenue category of taxes one level further (right-hand chart in figure V.3) shows that developed countries rely more heavily on income taxes (50 per cent of taxes) than developing countries (one third of taxes). Other tax components are far more important in developing countries, especially indirect taxes on goods and services (such as value added tax or VAT) at nearly half of total taxes.

It is worth noting that taxes on international trade transactions constitute a sizable component (one fifth) of tax revenues in LDCs, which may be important in the context of ongoing and future trade liberalization processes at regional or multilateral levels.

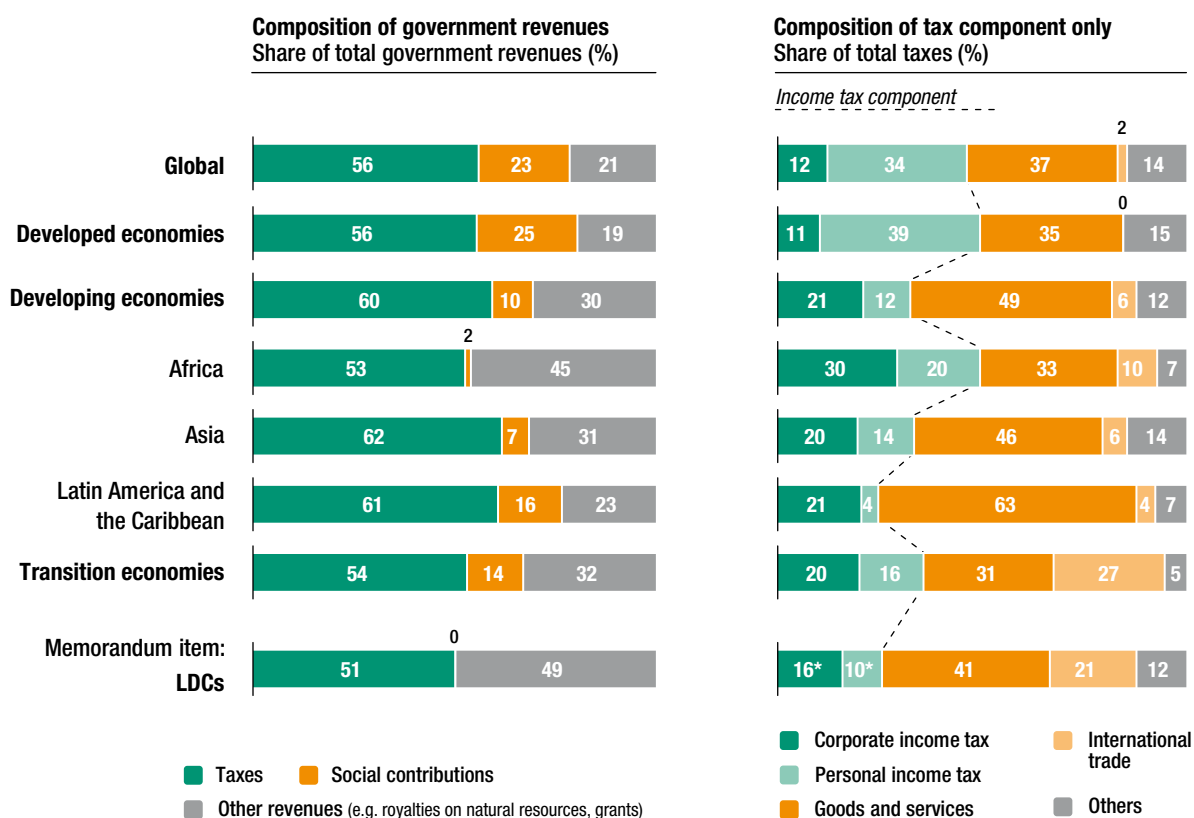
- iii. Corporate income taxes are relatively more important in the composition of taxes for

developing countries than for developed countries: at about 20 per cent of total taxes, they are nearly twice as important. Conversely, the share of personal income taxes is much more limited in developing economies. In developing countries, corporate taxes yield two thirds of all income taxes; in developed countries, only one quarter. Accordingly, as a share of GDP, corporate income tax amounts to almost 4 per cent of GDP in developing economies against 2 per cent in developed economies; by contrast, the share of personal income taxes falls to 2 per cent of GDP in developing economies against 8 per cent in developed economies.

The main patterns, (i), (ii), and (iii), resulting from the regional comparison are fully confirmed (and possibly strengthened) when adopting an income-driven perspective (figure V.4).

It appears that for assessing the relative collection capabilities of economies in different regions the revenue category of social contributions and the tax categories of personal income tax and indirect taxes represent the most useful proxy indicators. Although social contributions and personal income taxes are clearly linked to overall income levels and can thus be expected to amount to less in low-income countries, these categories also require the more sophisticated

Figure V.3. Composition of government revenues, by region (Per cent)



Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset.

Note: The classification is generally based on the standard IMF Government Finance Statistics classification. However, in the left-hand graph the category "other revenues" includes grants (these are very small, at 1.5 per cent of total government revenues in developing economies). In the right-hand graph, income taxes (corporate and personal) reflect the IMF category "taxes on income, profit and capital gains" ("payable by corporations and other enterprises" and "payable by individuals"). The residual category "others" includes taxes on payroll and workforce, taxes on property and other taxes. Data with (*) subject to very limited coverage. Full details on data sources and methods provided in annex I.

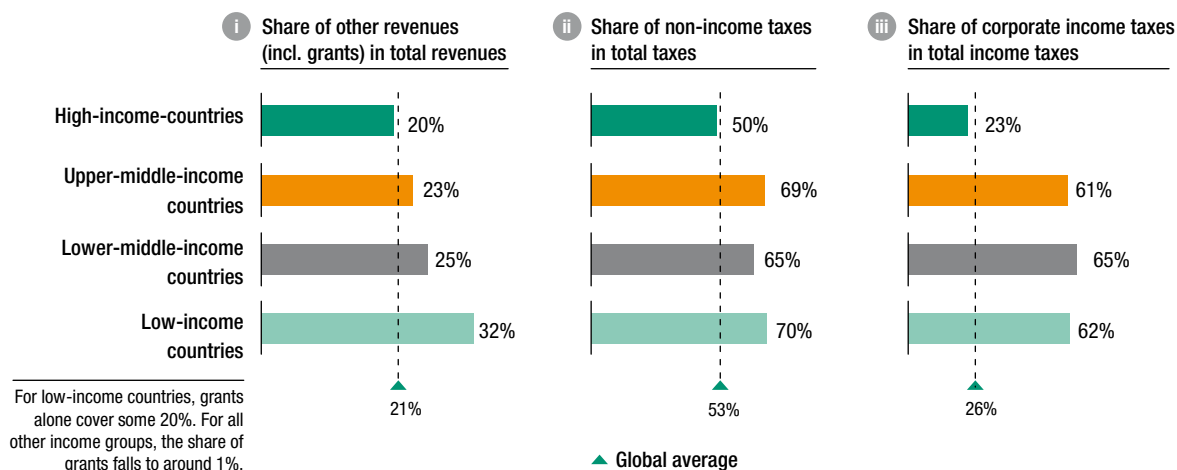
institutional structures and collection capabilities. In contrast, indirect taxes are easier to collect. Lower shares of social contributions and personal income taxes and higher shares of indirect taxes seem to be associated with lower collection capabilities and a greater reliance on corporate income taxes.

Interestingly, corporates are instrumental in collecting all three of these categories. While they do not actually pay personal income taxes and indirect taxes out of their own pockets in theory (leaving aside specific fiscal issues such as non-recoverable VAT) they collect these taxes on behalf of government through their payrolls and from their customers. This role, not explicitly quantified in the assessment of corporate contributions, represents a significant additional

element of fiscal value added – of crucial importance in developing countries with large informal economies.

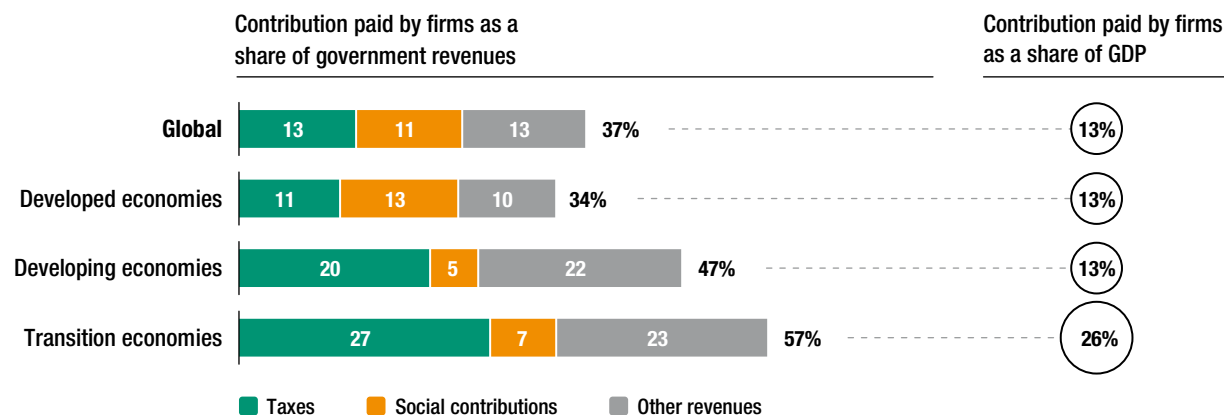
Looking specifically at the (paid) contribution of corporates (domestic and foreign firms) across all three categories of government revenues – taxes, social contributions and other revenues – confirms the significantly higher relative contribution in developing countries (almost half of government revenues) compared with developed countries (one third) (figure V.5). The difference is caused, as noted before, by higher revenues from corporate taxes (income taxes as well as taxes on international trade and other levies) and from relatively higher corporate contributions to other revenues, especially from natural resources and property. Relative to the size of the economies, the

Figure V.4. Key patterns in the composition of government revenues related to income levels (Per cent)



Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset.
 Note: Full details on data sources and methods provided in annex I.

Figure V.5. Contribution to government revenues by firms, domestic and foreign (Per cent)



Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset; IMF Government Financial Statistics database as complementary source.
 Note: Full details on data sources and methods provided in annex I.

corporate contribution to government revenues is practically the same across developed and developing economies at 13 per cent of GDP. The higher relative contribution of firms to government revenues in transition economies is due to relatively high income from natural resources and to the role of state-owned enterprises in the economy.

To sum up, government revenue collection capabilities are largely a function of levels of income and development. At lower levels of development, corporate

contributions to overall revenues and to income taxes are more important due to the low levels of collection of other revenue and tax categories. In addition to taxes paid by corporates, a significant amount of other taxes (especially indirect taxes) depend on collection by corporates. Overall, developing countries rely more on corporates for government revenue collection than do developed countries; as a share of the total economy, fiscal contributions by corporates are at similar levels in developed and developing countries.

2. The contribution of MNEs to government revenues

MNEs are important tax contributors worldwide, and in developing countries in particular. UNCTAD estimates the contribution of foreign affiliates to government budgets in developing countries at about \$730 billion annually. This represents, on average, about 23 per cent of corporate payments and 10 per cent of total government revenues. (In developed countries these shares are lower, at roughly 15 per cent and 5 per cent, respectively, underlining the higher dependence of developing countries on foreign corporate contributions). African countries show the highest relative contribution of foreign affiliates, at more than a quarter of corporate contributions and at 14 per cent of total government revenues. Overall, contributions through royalties on natural resources, tariffs, payroll taxes and social contributions, and other types of taxes and levies are on average more than twice as important as corporate income taxes.

The previous section looked at the level and composition of overall government revenues and at the contribution made by corporates (domestic and foreign firms). This section zooms in on foreign affiliates³ specifically. In order to do so, two new approaches to estimating MNE fiscal contributions have been developed:

1. *Contribution Method.* This approach is based on the economic contribution of foreign affiliates to host economies. It estimates the share of economic activity generated by foreign affiliates (profits, employment, value added, exports) and applies it to relevant components of the corporate contribution.
2. *FDI-Income Method.* This approach is based on country-by-country balance-of-payments data on FDI income. For the main developing regions it estimates the corporate income taxes paid by foreign affiliates by applying a suitable average effective income tax rate to the equity component of FDI income. It then calculates the contribution items other than income taxes based on the estimated weight of income tax in the total contribution paid by the average corporation operating in the region.

The two approaches should not necessarily lead to the same result. In fact, the FDI-income method should in theory yield a lower-bound estimate, given that it can take into account only the income on the foreign-

owned part of directly invested enterprises, rather than the full income of foreign affiliates (although the difference should not be large). Nevertheless, the estimates are broadly consistent, putting the total contribution of MNE foreign affiliates to developing-country government revenues at around \$730 billion annually, representing the midpoint of a range, including a lower bound of about \$650 billion and an upper bound of about \$800 billion. Apart from serving as a cross-check, the two independent approaches allow for different perspectives and provide different insights, discussed below. Comprehensive details on data and statistical methods are contained in annex I; box V.2 provides a brief summary of limitations of the approach and alternative assumptions.

Figure V.6, based on the contribution method, provides the relevant orders of magnitude and shares for developing economies, from total government revenues to the total contribution of foreign affiliates and the breakdown across the main contribution items. Out of total government revenues of \$6.9 trillion (27 per cent of 2012 GDP, see figure V.1), 47 per cent is paid by the corporate sector (see figure V.5), corresponding to some \$3.2 trillion. The share of the corporate contribution pertinent to foreign affiliates is about one quarter (23 per cent), corresponding to \$725 billion or 10 per cent of total government revenues. This contribution includes 60 per cent (\$430 billion) of taxes and social contributions and 40 per cent (\$295 billion) of other revenues. The bulk of these other revenues represents royalties on natural resources.

Within taxes, the subcategories show a slightly different pattern than for corporates as a whole (including domestic firms). While the corporate income tax component is similar, at half of total taxes and social contributions, the share of taxes on international trade transactions is relatively higher for foreign affiliates, at 20 per cent, due to the large share of exports accounted for by foreign affiliates in many developing countries (see *WIR13*). In contrast, the share of payroll taxes and social contributions paid by foreign affiliates is relatively low compared with that paid by domestic firms due to the more capital-intensive nature of many of their operations. Clearly this is an aggregate developing-country picture, with large variations for individual countries and regions, explored below.

As discussed in the previous section, in addition to taxes *paid* by foreign affiliates, which include not

only corporate income taxes but also payroll taxes and social contributions, taxes on international transactions, and a host of other taxes, levies and fees, MNEs contribute to government revenues by *collecting* income taxes from employees, as well as indirect taxes. These taxes are not borne by the MNE; they represent only a compliance cost. In economies with large informal sectors or with relatively limited collection capabilities in the tax authorities, this role can be very important. The collection of taxes on goods and services (e.g. VAT) is especially relevant, as it represents the largest component of developing countries' total tax revenues (at about 50 per cent). As a consequence, tax collection contributions by MNEs are also relevant, covering another 6-plus per cent of government revenues.

Leveraging the FDI-income method to look at the pattern by region (figure V.7), the average 10 per cent foreign affiliate contribution to government revenues becomes 14 per cent in Africa and 9 per cent

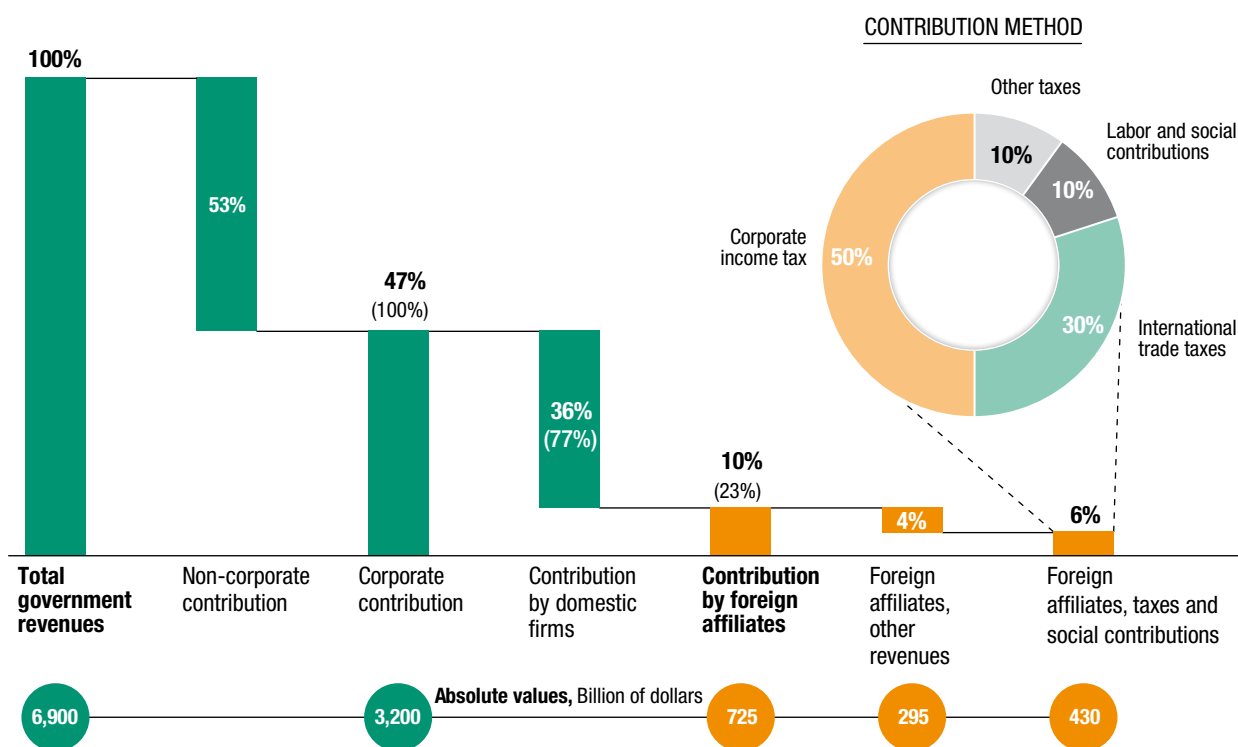
in Latin America and the Caribbean (down to 5 to 7 per cent in South America, compensated by higher shares in the Caribbean), with developing Asia representing the average as well as the bulk of overall absolute contributions. The regional variation reflects in part the relative importance of foreign affiliates in the economy of each region, and in part the foreign affiliate contribution to other revenues – in particular to royalties on natural resources. The relative shares of tax and social contributions seem comparable across regions, although when considering South America separately, the relative share of other revenues (resource-related) increases. Summing foreign affiliates' fiscal contributions across regions leads to a global contribution of \$730 billion, in line with the value reported in figure V.6 through the contribution method.

The methodology developed in this chapter not only provides inputs relevant to the international discussion on MNE taxation and development, especially through the establishment of a baseline for the actual

Figure V.6.

Government revenues contributed by foreign affiliates of MNEs

Share of government revenues, developing countries, reference year 2012
(Per cent and billions of dollars)



Sources: UNCTAD estimates, based on the ICTD Government Revenue Dataset; IMF Government Financial Statistics database; United Nations System of National Accounts; Eurostat; U.S. Bureau of Economic Analysis; International Labour Organization; literature review.
Note: Estimates represent range midpoints. Details on data and methods contained in annex I.

Box V.2.

Limitations, alternative assumptions and further research

The analysis of the contribution of MNE foreign affiliates to government revenues presented in this section aims to arrive at meaningful “order of magnitude” estimates. Both the economic contribution and the FDI-income methods developed for this analysis rely on assumptions and approximations to overcome the paucity of relevant data available. The following are some of the most important limitations and assumptions. Full details can be found in annex I.

A meaningful estimate of the actual contribution of foreign affiliates must be calculated net of any profit shifting. The contribution method, however, cannot exclude one form of profit shifting, thin capitalization, because it relies on the national accounts concept of operating surplus to derive profit ratios. A simulation of the impact of this limitation, using extreme assumptions, would bring down the overall contribution from \$730 billion to about \$650 billion – the lower bound of the estimation range. The separate FDI-income method does not present this problem.

The contribution method has another limitation. It does not separate corporate and non-corporate business income in the baseline for the calculation of foreign affiliates’ contribution to corporate income. Removing non-corporate business income, which would be unlikely to contain any foreign affiliate contribution, would have the effect of increasing the foreign affiliate share in the remaining corporate income part, thereby increasing the share paid by foreign affiliates in total corporate income taxes. Simulation of this effect yields the upper-bound estimate for the total foreign affiliate contribution of about \$800 billion. Again, the FDI-income method does not present this problem.

Assumptions regarding the average effective tax rate (ETR) paid by foreign affiliates play an important role, in particular in the FDI-income method. In that method, the ETRs for the developing regions, ranging between 20 and 25 per cent, are based on external studies and confirmed by UNCTAD’s own firm-level analysis, which also finds that ETRs for foreign affiliates and domestic firms are substantially aligned. Other studies have also found no evidence of a substantial difference in ETR between domestic companies and MNEs. The contribution method does not use a specific ETR but, consistent with the empirical findings, it uses the assumption that rates are the same for foreign affiliates and domestic firms.

As uniform ETRs for foreign affiliates and domestic firms may appear counter-intuitive, two important points should be made:

- The fact that domestic firms and foreign affiliates are found to have similar ETRs does not preclude that MNEs, at the consolidated level, may have significantly lower ETRs due to base erosion and profit shifting. (ETRs are calculated on the tax base that remains in foreign affiliates after profit shifting.)
- Many developing countries provide fiscal incentives to MNEs, which (insofar as they lower the tax rate rather than the base) would normally imply lower ETRs for foreign affiliates than for domestic firms. While incentives may have a significant impact at the individual country level, at the aggregate level the empirical evidence does not clearly show this. Better and more disaggregated data and further research will be needed to quantify the effect of fiscal incentives.

Finally, a number of assumptions have been made regarding the corporate shares of government revenues across individual revenue categories. These ultimately feed into both the contribution and the FDI-income methods. For each revenue category, the estimation approach determines whether the contribution is made by corporates, made partly by corporates, or not made by corporates. Varying allocations are of course possible and may lead to a wider range of estimates. However, the allocation criteria used here reflect the formal definition and the default application of each revenue category. Different criteria would require the introduction of additional assumptions.

To date, the methods and estimates presented here represent the most comprehensive and systematic picture of the total fiscal contribution of MNE foreign affiliates. Future research efforts may build on the approach developed in this section, experiment with different assumptions, explore methods to reduce approximation errors and, most useful of all, seek ways to disaggregate data at the country level.

Source: UNCTAD. Full details are provided in annex I.

value at stake, but *from the business perspective* it also provides an indication of the *fiscal burden* for the average foreign affiliate. Adopting an approach similar to the World Bank’s *Paying Taxes* study, the fiscal burden for foreign affiliates is measured as the ratio between the fiscal contribution and an adjusted measure of profits (“commercial profits” in the *Paying Taxes* terminology), gross of all relevant contribution items (including above-the-line contribution items).

The resulting fiscal burden on MNE foreign affiliates – taking into account taxes and social contributions only – represents approximately 35 per cent of commercial profits (figure V.8). The inclusion of “other revenues” (in both the numerator and the denominator of the ratio) significantly increases the estimate of the fiscal burden compared with that found using the more standard approach of considering only taxes and social contributions. The total contribution to government

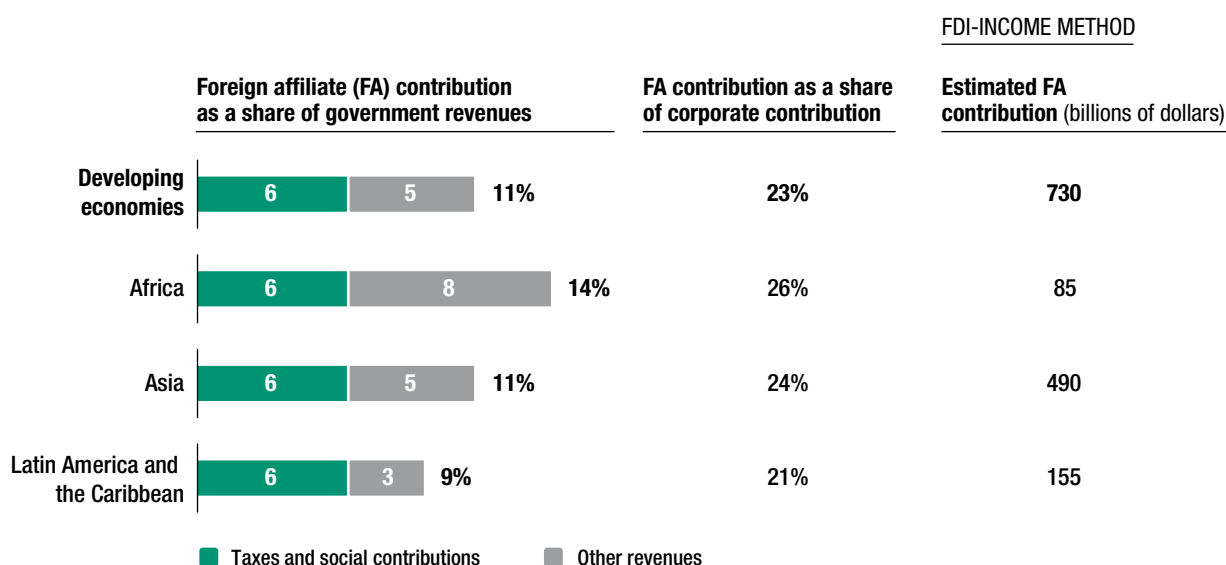
revenues represents about 50 per cent of foreign affiliate commercial profits, with minor variations by region.

Comparison with the same calculation for developed economies reveals that the fiscal burden based only on taxes and social contributions is lower in developing

economies (35 per cent of commercial profits against 56 per cent in developed economies); however, including other revenues in the equation leads to a partial convergence of the ratios (50 per cent in developing economies against 65 per cent in developed economies).

Figure V.7.

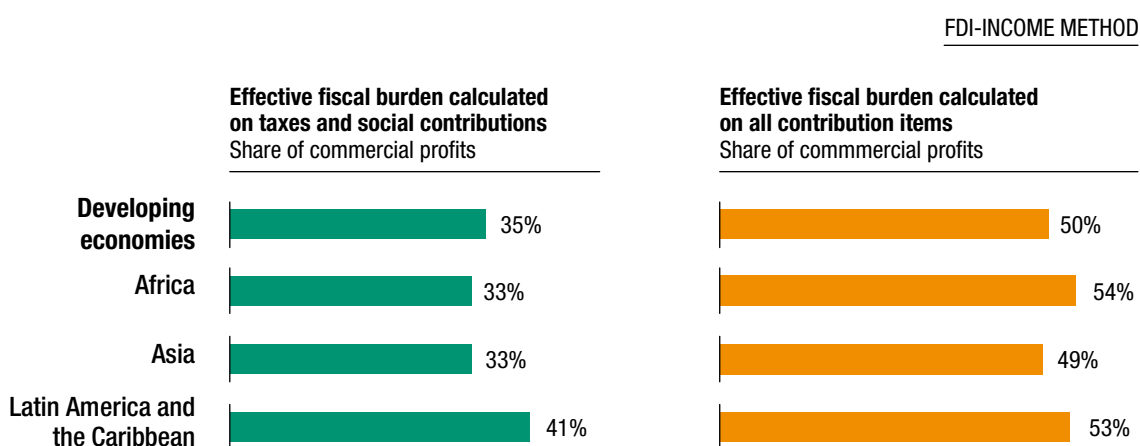
Government revenues contributed by foreign affiliates of MNEs, by developing region
Reference year 2012 (Per cent and billions of dollars)



Sources: UNCTAD estimates, based on the ICTD Government Revenue Dataset; IMF Government Financial Statistics database; IMF Balance of Payments Statistics.
Note: Details on data and methods contained in annex I.

Figure V.8.

The fiscal burden on foreign affiliates of MNEs (Per cent)



Sources: UNCTAD estimates, based on the ICTD Government Revenue Dataset; IMF Government Financial Statistics database; IMF Balance of Payments Statistics.
Note: Details on data and methods contained in annex I.

B. AN INVESTMENT PERSPECTIVE ON INTERNATIONAL TAXATION

MNEs build their corporate structures through cross-border investment. They will construct those corporate structures in the most tax-efficient manner possible, within the constraints of their business and operational needs. The size and direction of FDI flows are thus often influenced by MNE tax considerations, because the structure and modality of investments enable tax avoidance opportunities on subsequent investment income. In tackling tax avoidance, most notably in the BEPS approach, the attention of policymakers focuses naturally on tax rules, company law and transparency principles – i.e. on accounting for income. The fundamental role of investment as the enabler of tax avoidance warrants a complementary perspective.

This section aims to provide a new perspective on corporate international taxation and MNE tax avoidance schemes. It integrates the mainstream approach of the BEPS project with an investment-based approach emphasizing the relevance of corporate structures set up by channelling FDI through offshore investment hubs and OFCs, notably *tax havens* and jurisdictions offering so-called *special purpose entities* (SPEs),⁴ as these are the *enablers* of most BEPS schemes.⁵ In essence, corporate structures built through FDI can be considered “the engine” and profit shifting “the fuel” of MNE tax avoidance schemes.

In order to analyse the scope, dimensions and effects of tax-efficient corporate structures (“fuel-efficient engines”), the section looks at FDI flowing through OFCs or conduit jurisdictions (transit FDI). It is important to emphasize from the outset that the notion of transit FDI does not equate with non-productive FDI. FDI designed as part of tax planning strategies of MNEs may or may not have a real economic impact on the countries involved. For example, an investment from a North American firm in Asia to start a new production plant may be channelled through Europe for tax reasons (potentially penalizing tax revenues in both home and host countries) but still carry the productive-asset-creating effects of a greenfield investment. By contrast, transit FDI tends to have very little real economic impact in countries acting as investment hubs in MNE tax planning schemes.

For the purpose of the analysis in this section, a simple (and conservative) approach has been taken

to identifying offshore investment hubs, limiting the scope to tax havens and a few jurisdictions that (at the time of analysis for this chapter) explicitly publish directional SPE investment data.⁶ Other countries host SPEs and various types of entities that facilitate transit investments. Alternative approaches and perimeters for offshore investment hubs, combining generally accepted tax-based criteria with criteria based on objective FDI data, are discussed in annex II.

It should be noted that the conduit countries discussed in this section are not alone in offering certain tax benefits to foreign investors; a degree of tax competition has led many other countries to adopt similar policies. *No policy implications are implied by the scope of the perimeter for offshore investment hubs used in this section.* In fact, the analysis will show that any action on tax avoidance practices needs to address policies across all jurisdictions – in base (home) countries, conduit (transit) countries and source (host) countries alike.

1. The importance of offshore investment hubs and transit FDI

Offshore investment hubs play a major role in global investment. Some 30 per cent of cross-border corporate investment stocks (FDI, plus investments through SPEs) have been routed through conduit countries before reaching their destination as productive assets. The growth of transit investment saw a sharp acceleration during the second half of the 2000s.

In 2012, the British Virgin Islands were the fifth largest FDI recipient globally with inflows at \$72 billion, higher than those of the United Kingdom (\$46 billion), which has an economy almost 3,000 times larger. Similarly, outflows from the British Virgin Islands, at \$64 billion, were disproportionately high compared with the size of the economy. The British Virgin Islands are only one example of an economy with such unusual FDI behaviour. Such very different economies as the Netherlands and Luxembourg also exhibit amplified investment patterns.⁷ Despite their heterogeneity, all these countries act as offshore investment hubs for MNEs. Many of these hubs display some degree of the following characteristics: (i) no or low taxes;

(ii) lack of effective exchange of information; (iii) lack of transparency; (iv) no requirement of substantial activity.⁸

The investment analysis in this section, which provides a comprehensive map of corporate investment to and from offshore hubs, covers a set of 42 hubs differentiated in two groups:

- *Jurisdictions identified as tax havens.* Small jurisdictions whose economy is entirely, or almost entirely, dedicated to the provision of offshore financial services.
- *Jurisdictions (not identified as tax havens) offering SPEs or other entities that facilitate transit investment.* Larger jurisdictions with substantial real economic activity that act as major global investment hubs for MNEs due to their favourable tax and investment conditions.

In the absence of any universally agreed approach to classifying offshore investments and investment hub activity, this chapter has opted for a narrow and conservative perimeter of analysis based on a list of tax havens originally proposed by the OECD⁹ and a limited set of SPE jurisdictions, which are those that have a long-standing record of published SPE data, with the Netherlands and Luxembourg accounting for the lion’s share. It should be noted that many other economies facilitate transit FDI in various ways. Annex II provides alternative options and results.

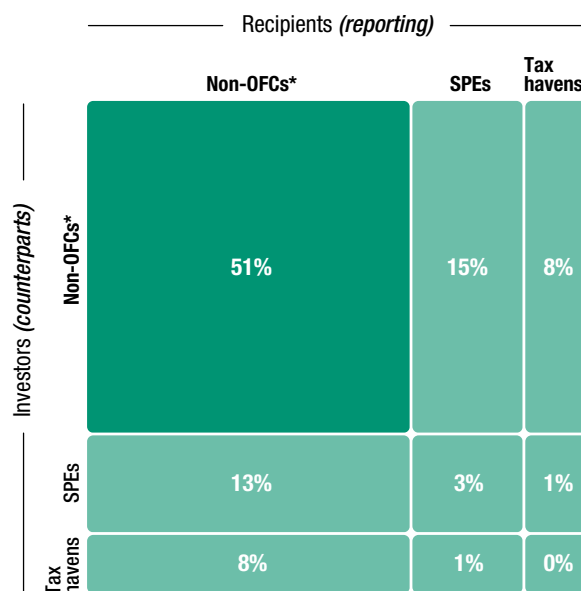
The Offshore Investment Matrix (figure V.9) provides a comprehensive mapping of corporate international investments through offshore investment hubs. For each “unit” of MNE international investment stock, bilateral data provide a pairing of direct investor and recipient jurisdictions, which are grouped under the categories *Non-OFCs*, *SPEs* or *Tax Havens*. When the investor/recipient is a jurisdiction that offers SPEs, only part of the outward/inward investment is allocated to transit investment activity (the *SPE component*) while the remaining part is allocated to the *Non-OFC component*. Full methodological details on the construction of the Offshore Investment Matrix are provided in annex II.

The matrix shows the pervasive role of offshore investment hubs in the international investment structures of MNEs, as already envisaged in *WIR13* and hinted at by other studies.¹⁰ In 2012, out of an estimated \$21 trillion¹¹ of international corporate

The Offshore Investment Matrix, 2012

Bilateral investment stocks by type of investor and recipient, share of total (Per cent share of FDI stock)

Figure V.9.



* Non-OFCs are stocks based in or coming from non-tax havens and non-SPE jurisdictions, and include the (FDI-) part of investment stocks in or from SPE jurisdictions not associated with SPEs.

$\Sigma = 100\% \approx \$ 29$ trillion
(2012 TOTAL INWARD FDI STOCK plus investment into SPEs)

Source: IMF Coordinated Direct Investment Survey 2012 and 2011; national statistics; UNCTAD estimates.

Note: Full details on the methodology provided in annex II.

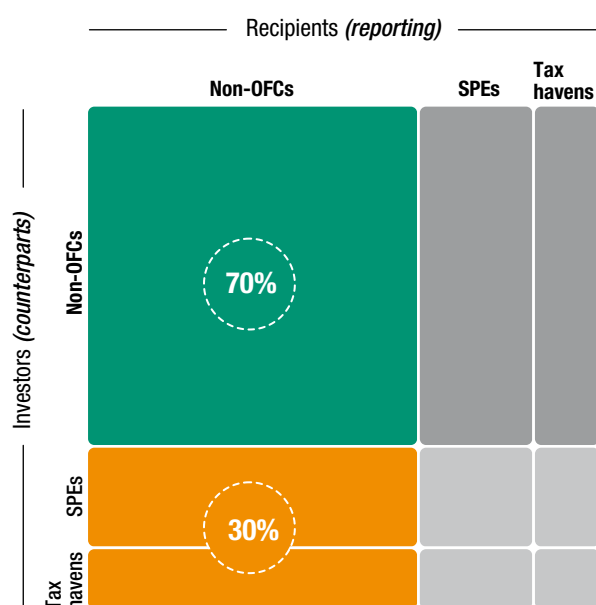
investment stock in *Non-OFC* recipient countries (the coloured area in figure V.10), more than 30 per cent, or some \$6.5 trillion, was channelled through offshore hubs (the orange area). The contribution of SPEs to investments from conduit locations is far more relevant than the contribution of tax havens. The largest offshore investment players are SPE jurisdictions.

A mirror analysis of the inward investment into offshore hubs (the dark grey area in figure V.10 on the next page) reveals that 28 per cent of the total amount of cross-border corporate investment stock is invested into intermediary entities based in hubs. In some cases, these entities may undertake some economic activity on behalf of related companies in higher tax jurisdictions, such as management services, asset administration or financial services (*base companies*). However, often they are equivalent

Figure V.10.

Non-OFC inward investment stocks, by type of investor

Vertical view of the Offshore Investment Matrix (Per cent)



Source: IMF Coordinated Direct Investment Survey 2012 and 2011; national statistics; UNCTAD estimates.

Note: Full details on the methodology provided in annex II.

to letterbox companies, legal constructions conceived for tax optimization purposes (*conduit companies*) and potentially to benefit from other advantages associated with intermediate legal entities. The prominent *pass-through* role of these entities in financing MNE operations causes a degree of *double counting* in global corporate investment figures, represented by the dark grey area in the Offshore Investment Matrix (inward investments into offshore hubs), which broadly mirrors the orange area (outward investments from hubs).¹² In UNCTAD FDI statistics this double-counting effect is largely removed by subtracting the SPE component from reported FDI data.

The share of stock *between* hubs (light grey area) is also relevant, at 5 per cent of global investment stock. This confirms that offshore investment hubs tend to be highly interconnected within complex multilayered tax avoidance schemes. The “*Double Irish-Dutch Sandwich*” employed by IT multinationals is a relevant example of such structures.

An analysis of the Offshore Investment Matrix by the two investment components, *Equity* and *Debt*,

reveals additional dynamics. The picture for the debt component (figure V.11.b) show a significantly larger role for hubs (and especially SPEs) compared with the general pattern. This captures a typical tax avoidance mechanism whereby an SPE channels funds through intracompany loans to third-country affiliates. The basic rationale of this practice is to generate an erosion of the tax base in the recipient (high-tax) jurisdiction, with profit shifted to low-tax locations in the form of deductible interest payments.¹³

The scenario represented in figures V.9 through V.11 is the result of a boom in the use of offshore structures in cross-border corporate investment. Between the start and end of the 2000s, the average share of investment flows to non-OFC countries routed through offshore hubs increased from 19 to 27 per cent (figure V.12). More recently, greater international efforts to tackle tax avoidance practices have managed to reduce the share of offshore investments in developed countries, but the exposure of developing economies to such investments is still on the rise (see also section C).

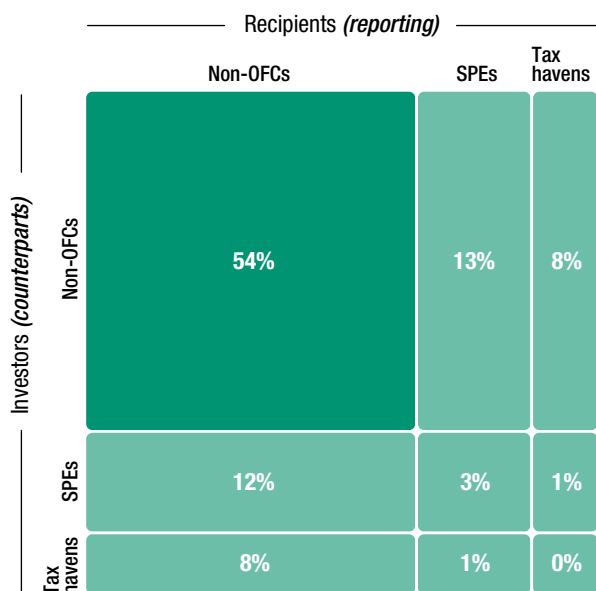
2. The root causes of the outsized role of offshore hubs in global investments

The root cause of the outsized role of offshore hubs in global corporate investments is tax planning, although other factors can play a supporting role. MNEs employ a wide range of tax avoidance levers, enabled by tax rate differentials between jurisdictions, legislative mismatches and gaps, and tax treaties. MNE tax planning involves complex multilayered corporate structures. From an investment perspective, two archetypal categories stand out: (i) intangibles-based transfer pricing schemes and (ii) financing schemes. Both schemes, which are representative of a relevant part of tax avoidance practices, make use of investment structures involving entities in offshore investment hubs.

The investment data and the results of the analyses depicted in the previous section highlight the massive and still growing use of offshore investment hubs by MNEs. Offshore investment structures are an integral part of MNE tax planning strategies aimed at shifting profits from high-tax to low-tax jurisdictions in order to reduce corporate tax bills. What makes them attractive for tax optimization purposes is usually a mix of features. Corporate tax is often reduced to minimal levels through preferential regimes. Some

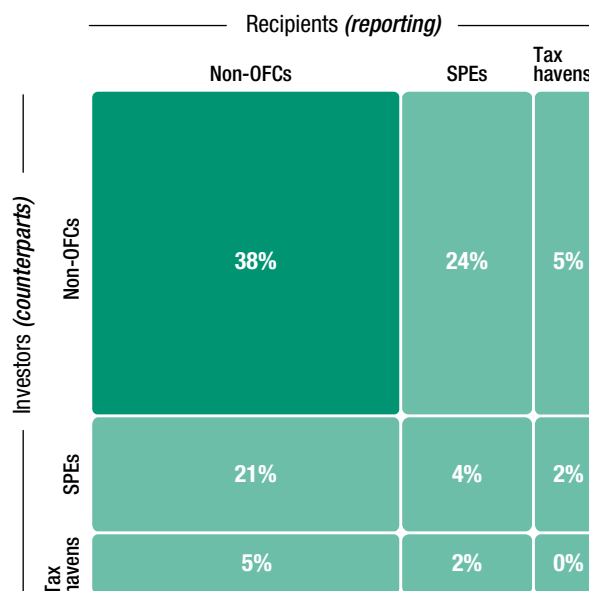
Figure V.11. The Offshore Investment Matrix, by investment component
(Per cent share of FDI stock)

a. Equity



$\Sigma = 100\% \approx \$24$ trillion (corresponding to 82% of total FDI stock)

b. Debt instruments



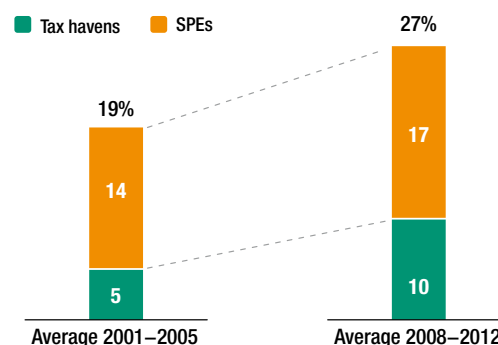
$\Sigma = 100\% \approx \$5$ trillion (corresponding to 18% of total FDI stock)

Source: IMF Coordinated Direct Investment Survey 2012 and 2011; national statistics; UNCTAD estimates.
Note: The methodology follows directly from the general case illustrated in figure V.9 and explained in annex II.

of these jurisdictions offer the option to negotiate tax rates or obtain favourable tax rulings from tax authorities. In addition, they may offer special vehicles (special types of entities such as holding structures, foundations, cooperatives, etc.), which result in both tax and operational advantages. Offshore hubs are usually effective in circumventing withholding taxes. For instance, most SPE jurisdictions do not apply withholding taxes on outflows and ensure that withholding tax on inflows is limited through the application of tax treaties. SPE jurisdictions tend to have extensive treaty networks, making them ideal intermediary or regional headquarter locations.

An objective discussion on the root causes of the role of offshore investment hubs, and in particular SPE jurisdictions, in international investment should take into account other factors. Some jurisdictions count on extensive networks of investment treaties providing investor protection and access to international arbitration. In addition, offshore hubs tend to require

Figure V.12. Trend in the share of investment inflows from offshore hubs, 2001–2012 (Per cent)



Source: UNCTAD FDI database; national statistics; UNCTAD estimates.
Note: Elaboration of UNCTAD bilateral flow statistics. The target sample of (recipient) reporting countries includes all countries reporting bilateral investments flows with the exclusion of offshore hub countries (tax havens and the selected countries reporting SPEs). This approach makes it possible to describe the trend in the penetration of offshore investments in “real” economies while removing the (distorting) effects of investments between hubs. In the context of flow analysis, averaging across multiple years is helpful to mitigate the volatility of the offshore component and capture the underlying trend. For the countries reporting SPEs, the share of SPEs in total outflows is derived from central bank data.

relatively few formalities for the set-up of investment vehicles and offer attractive business climates. Countries providing homes to SPEs generally have strong legal and regulatory frameworks, good in-country infrastructure and sophisticated banking environments and are stable from an economic and political perspective. They also offer other advantages such as a skilled labour force and an established business services industry. Geographical location and language are other important factors. However, the relative importance of non-tax factors in making SPE jurisdictions successful investment hubs should not be overestimated. For example, only one third of investment channelled through SPEs in the Netherlands goes to countries with a bilateral investment protection treaty in place.¹⁴

There is significant anecdotal evidence of the occurrence of profit shifting through offshore investment hubs. Google achieved an effective tax rate of 2.4 per cent on its non-United States profits in 2009 by routing profits to Bermuda, with Ireland and the Netherlands playing a key role in the structure. Many examples of multinational corporations that achieved similar results or utilized similar structures have appeared in the media in recent years and will be familiar to the public.

A more systematic, not anecdotal, assessment of BEPS practices at the *firm level* is difficult. MNEs have very limited interest in disclosing tax-relevant information, especially on their cross-border operations. Figure V.13 shows some basic firm-level evidence confirming the special role of offshore hubs in MNE investment structures based on United States

data. Box V.3, at the end of this section, outlines promising directions of future research using firm-level data at the subsidiary level.

MNEs resort to a large number of tax avoidance levers. Table V.1 lists the main ones, categorized according to three enabling factors: tax rate differentials, legislative mismatches or gaps, and double taxation treaties.

The tax avoidance levers listed in table V.1 are rarely used alone. They synergize in complex multilayered schemes in which one or more layers involve an offshore hub as a *facilitator*. According to the OECD (2013a), optimized schemes typically minimize taxes under four different aspects:

- a. *Minimization of taxation in a foreign operating or source country* (which is often a medium- to high-tax jurisdiction) either by shifting gross profits via trading structures or reducing net profit by maximizing deductions at the level of the payer.
- b. *Low or no withholding tax at source.*
- c. *Low or no taxation at the level of the recipient* (which can be achieved through low-tax jurisdictions, preferential regimes or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built up through intragroup arrangements.
- d. *No taxation of the low-taxed profits at the level of the ultimate parent.*

In practice there may be innumerable combinations of tax avoidance levers to achieve tax minimization. A consolidated approach found in the empirical literature is to focus on two archetypal categories

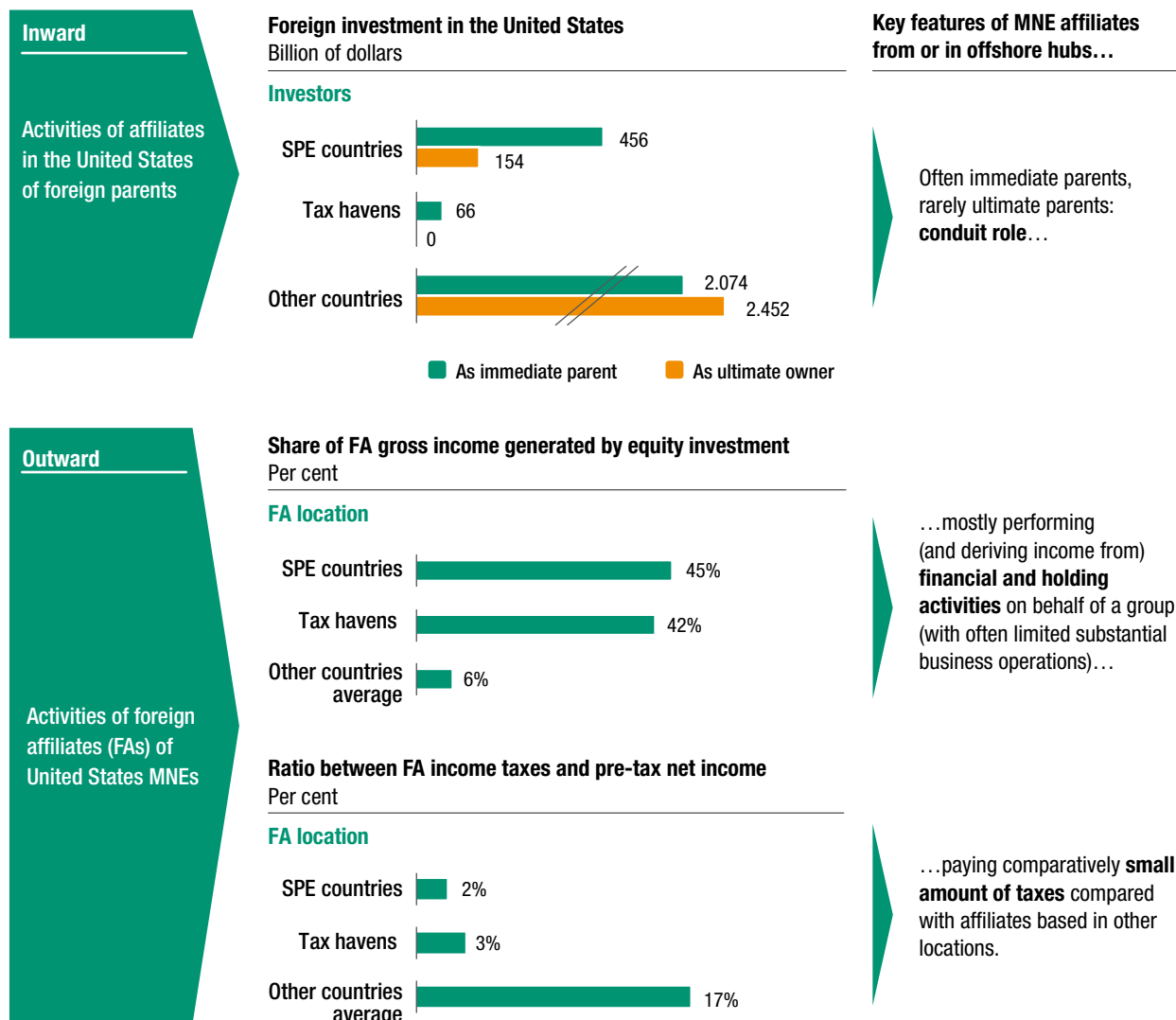
Table V.1.

Overview of the main tax avoidance levers

Enabling factor	Specific levers
Tax rate differentials	<ul style="list-style-type: none"> • Transfer pricing manipulation (trade mispricing, use of intangible/IP, commissionaire structures) • Excessive debt financing • Others (e.g. location planning, loss utilization)
Legislative mismatches and/or gaps	<ul style="list-style-type: none"> • Hybrid mismatches • Derivative transactions • Disguised domestic investments • Deferred repatriation
Double taxation treaties	<ul style="list-style-type: none"> • Treaty shopping • Triangular structures • Circumvention of treaty thresholds

Source: UNCTAD.

Figure V.13. Selected firm-level evidence on the special role played by tax havens and SPEs in MNE investment structures, 2012



Source: United States Bureau of Economic Analysis (BEA); UNCTAD analysis.

Note: Statistics for the group of "SPE countries" are based on Luxembourg and the Netherlands; for the group of "tax havens" on British Virgin Islands.

addressing the most relevant tax avoidance schemes: first, *intangibles-based transfer pricing* schemes and, second, *financing* schemes.¹⁵ Although the precise separating line between the two is not always clear, both conceptually and empirically,¹⁶ it is still valuable to analyse their distinctive features.

(i) Archetype 1: Intangibles-based transfer pricing schemes

The essence of these schemes is to transfer profit to low-tax jurisdictions through transfer pricing

manipulation on intangibles (and associated royalties and licensing fees), generating a divergence between where value is created and where taxes are paid. The higher the intangible component of value creation (IP rights, brands, business services, risks), the higher the profit-shifting opportunities. With the very high share of profits of large MNEs based on what they know rather than what they make, the relevance of this type of scheme is clear, as witnessed also by the continuing trend to introduce so-called IP boxes, where the income on intangibles is taxed at low rates.

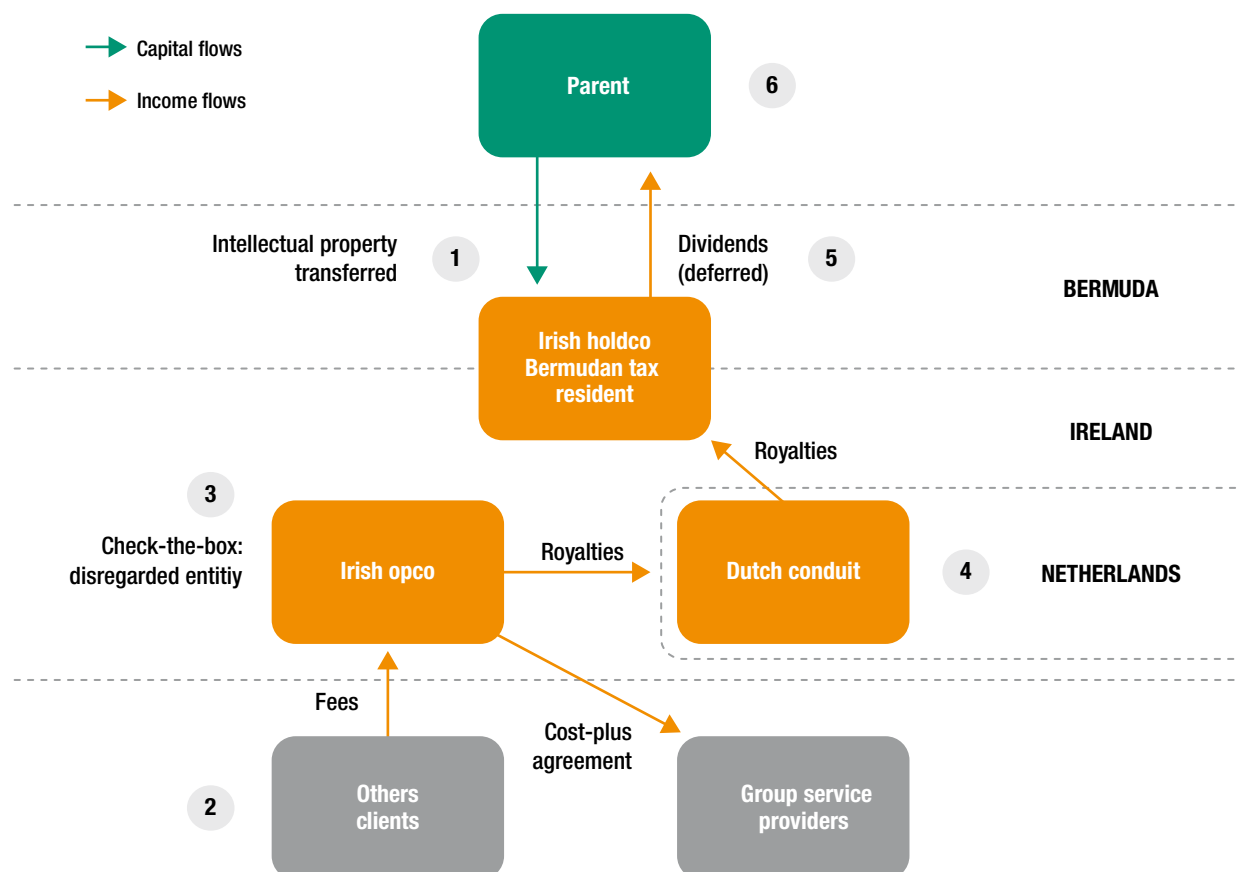
It should be noted that, although intangibles-based schemes are increasingly relevant at the global level, transfer pricing manipulation related to intra-firm trade (trade mispricing) of tangible goods is also common, especially to the detriment of developing economies where basic expertise and instruments to detect transfer pricing abuses are missing.¹⁷ For a broader discussion of issues related to abusive transfer pricing by MNEs and possible policy directions to reform the current arm's-length standards, see Eden (2014).

Typical examples of intangibles-based transfer pricing schemes are in the IT sector where the high-value share of the IP rights (with base erosion opportunities related to high royalty payments) and the digitalization of business operations (with the possibility to separate physical presence from value creation) create a

formidable synergy to minimize taxes. OECD countries where IT firms generate most of their value have been particularly exposed to these types of schemes. The case between the United Kingdom and Google has become exemplary¹⁸ but it is not the only one. Governments around the world, especially in OECD countries, are stepping up scrutiny of tax affairs of the major multinational players in the digital economy. It is not surprising that transfer pricing in the digital economy stands out as a top priority in the OECD/G20 Action Plan.¹⁹ Figure V.14 illustrates the “Double Irish-Dutch Sandwich”, a structure that has become infamous after the Google case.

Although MNEs in the IT sector do not necessarily all use exactly the same technique, the strategies they use follow very similar patterns. The scheme

Figure V.14. Example: Double Irish-Dutch Sandwich



consists of a main tax avoidance lever (transfer pricing manipulation through the use of intangibles) and a number of ancillary tax avoidance levers (including treaty shopping, hybrids, deferred repatriation and commissionaire structures) that in combination achieve the four objectives (a)-(d) listed above, as described in the following example.

a. Minimization of taxation in a foreign operating or source country.

(1) IP is transferred by a United States parent company (high-tax jurisdiction) to an Irish-incorporated subsidiary that is tax resident in a low-tax jurisdiction (Bermuda). The transfer is usually done under a cost-sharing agreement when the IP is not yet fully developed and hence still has a fairly low value. The price can therefore be manipulated. The transfer value is further obscured by the fact that only the non-United States rights attached to the IP are transferred.

(2) The IP is sublicensed by the Irish IP Holding Company to an Irish Operating Company (incorporated and tax resident in Ireland). The Irish Operating Company exploits the IP and usually earns high revenues. Sales-supporting entities in the country of consumption are disguised as low-risk service providers operating under a cost-plus agreement, minimizing the tax base.

(3) The Irish Operating Company pays high tax-deductible royalties for the use of the IP held by the Irish IP Holding Company, offsetting the high revenues from sales and achieving significant erosion of the tax base.

b. Low or no withholding tax at source.

(4) The Irish Operating Company does not pay royalties to the IP Holding Company directly but through an intermediate company in the Netherlands. The intermediate company is an SPE without any substantial activity, interposed between the Irish Operating Company and the Irish IP Holding Company to avoid the payment of the withholding fees (withholding taxes would otherwise apply because the Irish IP Holding Company is a Bermuda tax resident and Ireland levies withholding taxes on royalty payments to Bermuda). Through interposition of the Dutch conduit, withholding taxes are fully circumvented. No withholding tax is levied on the royalty fees

through use of the EU interest and royalties directive, and the Netherlands does not impose withholding tax on royalty payments, irrespective of the residence state of the receiving company.

c. Low or no taxation at the level of the recipient.

(5) The Irish Holding Company, being a Bermuda tax resident, does not pay tax on its income in Ireland, and Bermuda does not levy corporate tax. The income is retained in the Irish Holding Company (i.e. not repatriated to the United States) to avoid United States tax.

d. No taxation of the low-taxed profits at the level of the ultimate parent.

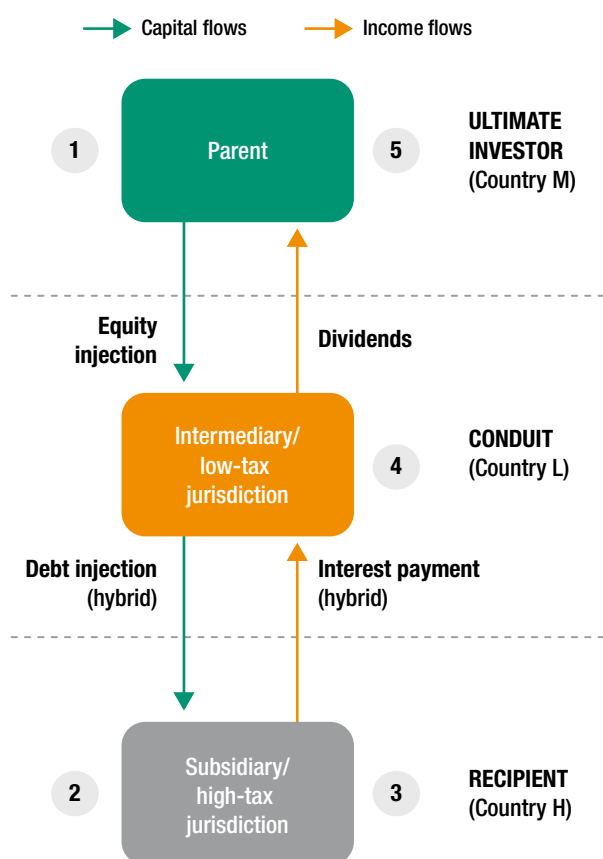
(6) The Irish Operating Company and Dutch conduit are elected in the United States as 'check-the-box' entities (transparent for United States tax purposes) and are hence disregarded by the United States. Thus no United States tax is levied on their income.

(ii) Archetype 2: Financing schemes

The underlying idea of financing schemes is to use loans from an offshore-based entity to maximize the payments of passive interests at the level of the (high-tax jurisdiction) loan recipient. This category can be generalized to include schemes involving all financing operations through offshore intermediate entities in order to reduce the tax bill. In addition to debt financing, other financial operations conveniently manageable through offshore investment hubs may include merger and acquisition operations where the sale of assets is managed through an affiliate in an offshore hub to reduce taxes on capital gains, or leasing operations managed through intermediate entities in offshore hubs to maximize payments at the level of the operating company and thus to erode the tax base. Unlike the transfer pricing schemes described above, these schemes can be employed also in the presence of tangible assets and are particularly suitable for highly capital-intensive industries (such as the extractive industry). Furthermore, while transfer pricing schemes mostly penalize the country of consumption, this type of scheme hits the investment recipient country where operations take place (often developing countries). Although this type of scheme has had less visibility in the media than transfer pricing schemes, they are not less relevant.²⁰ NGOs are also increasingly recognizing the importance of this type of scheme.²¹

Figure V.15.

Example: Debt-financing structure using intermediate holding company and hybrid instrument



Source: UNCTAD based on OECD (2013a).

From an investment perspective, this archetypal scheme is particularly interesting as it is directly visible in FDI data, as illustrated by the debt versus equity analysis in the Offshore Investment Matrix.

Also for this category it is possible to identify some notable examples, as illustrated in figure V.15. As in the case of the Double Irish-Dutch Sandwich, the scheme is founded on a basic concept built around the use of debt financing for base erosion, and combined with further levers, including treaty shopping and hybrids, in order to optimize the tax planning strategy along the four objectives explained above, as described in the following example.

a. Minimization of taxation in a foreign operating or source country.

(1) Parent Company located in Country M (which could be a medium- or high-tax jurisdiction) injects equity funding into its intermediary in Country L, a low-tax jurisdiction.

(2) Intermediary Company injects funding into its subsidiary in Country H, a high-tax jurisdiction. It uses a hybrid instrument to do this; hence the funding is seen as an equity injection by Country L and debt funding by Country H. The funding may be either excessive or unnecessary from an economic perspective and also in relation to the real equity in the subsidiary; however Country H does not have any thin capitalization or similar rules.

(3) Subsidiary Company pays interest to Intermediary Company, which it deducts for its own tax purposes, thereby paying lower taxes in Country H.

b. Low or no withholding tax at source.

(3) The interest is not subject to withholding tax in Country H due to treaty application.

(4) Similarly, no withholding tax is levied on the interest – which is considered a dividend – in Country L due to treaty application.

c. Low or no taxation at the level of the recipient.

(4) The interest is seen as a dividend in Country L, and Country L does not tax dividends.

d. No current taxation of the low-taxed profits at the level of the ultimate parent.

(5) If a dividend is declared to the Parent, no tax is levied on the dividend in Country M due to a dividend exemption. Country M does not have CFC (controlled foreign company) or similar legislation in place.

Table V.2 summarizes the key features of the two types of schemes.

In conclusion, although some of the individual levers employed by MNEs to avoid tax, such as trade mispricing, may not necessarily involve offshore investment hubs, these levers are rarely deployed on their own. The archetypal schemes that are representative of the bulk of tax avoidance practices all make use of investment structures involving entities in offshore hubs.

Table V.2.

Comparison of the two archetypal tax avoidance schemes

	Archetype 1: Intangible based transfer pricing schemes	Archetype 2: Financing schemes
Objective	<ul style="list-style-type: none"> Transfer profit to low tax jurisdictions via transfer pricing manipulation on the intangibles 	<ul style="list-style-type: none"> Erode the taxable base at the level of the financing recipient through deductibles on interest payments
Notable examples	<ul style="list-style-type: none"> Double Irish-Dutch Sandwich 	<ul style="list-style-type: none"> Financing structure using an intermediate holding company and a hybrid instrument
Tax avoidance levers	<ul style="list-style-type: none"> Main: transfer pricing manipulation (use of intangibles/IP) Ancillary: treaty shopping, hybrids, deferred repatriation, commissionaire structures 	<ul style="list-style-type: none"> Main: debt financing Ancillary: treaty shopping, hybrids, deferred repatriation
Business implications	<ul style="list-style-type: none"> Intangible businesses, digital economy Service sector Higher impact on (mostly developed) economies where customers reside 	<ul style="list-style-type: none"> Tangible, capital intensive businesses Primary and secondary sector Higher impact on (mostly developing) economies where investments are made and operations take place

Source: UNCTAD.

Box V.3.

Investigating MNE tax avoidance practices at the firm level: possible research directions

Detailed balance sheet data and profit and loss account data on the affiliates of MNEs may enable further investigation of profit shifting and tax planning strategies. Financial information relevant for the analysis of MNE tax avoidance includes long-term loans, equity balances, revenues, gross profit, operating profit, financing costs, net profit and taxation. Asset values (especially fixed assets) and employee numbers are also important indicators.

Financial data inform a number of metrics that can be used as *tax avoidance signals*:

- Loan and equity balances* can be used to compare debt-equity ratios within peer groups in order to provide an indication of potentially excessive debt funding. The ratio of debt to (non-current) assets can also be used for this purpose. For debt-asset ratios, industry-specific analyses are needed to allow for differences between asset-intensive businesses and others. Financing costs as a percentage of interest-bearing debt can be used as a test on artificial inflation of the interest rate (related to transfer pricing abuses).
- Gross margins and operating margins* (i.e. gross profit and operating profit as a percentage of revenues) could be used to identify potential base erosion, with carefully selected peer group samples to reduce industry variations or factors.
- Tax-specific ratios* include tax as a percentage of revenues, gross profit or operating profit, which may provide insight into excessive deductions that are taking place in a company. Effective tax rates between domestic- and foreign-owned companies can also be compared, e.g. tax (current and deferred tax) over net profit (before tax).

Different approaches are feasible. For a target country, the expectation that foreign-owned companies are more prone than national ones to tax planning techniques can be tested. For a target *group of MNEs* (e.g. the top 100 global MNEs), the comparison could take place across subsidiaries of the same multinational corporate group with the purpose of identifying differences in profit levels, taxation and debt across countries in accordance with tax arbitrage strategies. In all cases, in addition to firm-level financials, complete visibility of the MNE ownership structure is necessary, which can be provided (with limitations on coverage and depth) by databases such as Orbis, maintained by Bureau van Dijk. UNCTAD aims to explore these options further in future work in this area.

Source: UNCTAD; Fuest and Riedel (2010).

C. MNE TAX AVOIDANCE AND DEVELOPING COUNTRIES

The process of formulating the SDGs and the related Financing for Development discussion have raised the political profile and public awareness of the role of taxation as a source of development financing and focused attention on the detrimental impact of tax avoidance schemes on developing economies.

Tax is a major component of the development financing pool. Concord (2013) estimates the total amount of domestic sources of development financing at some 60 per cent of the aggregate GDP of developing economies against 5 per cent for external sources, with taxation at 15 to 30 per cent of GDP, representing a significant share of domestic sources.²² The OECD²³ calculated in 2011 that at the aggregate global level up to half of annual additional resources needed to achieve the (first six) Millennium Development Goals (MDGs) could be recovered just by improving tax revenue collection in developing economies. The situation will be similar for the SDGs.

The concerns of development organizations and NGOs related to BEPS practices in developing countries centre on two issues: (i) developing economies are less equipped than developed economies to counter corporate tax avoidance, so therefore their *exposure* may be greater; and (ii) the *impact* in terms of resource losses for developing economies is significant, especially against the background of the scarcity of available local resources and the development financing gap.

The FDI-based analytical toolkit introduced in this section provides a methodology both to assess the exposure of developing economies to FDI from offshore investment hubs, and to estimate the resulting tax revenue losses. The distinctive feature and to some extent also the limitation of the approach is to focus specifically on the role and the impact of offshore hubs as immediate investors into developing economies. It is important to point out that a direct investment link to an offshore hub is not a prerequisite for profit shifting. However, such links enable some important forms of profit shifting and they are usually part of the tax planning strategy of MNEs. In particular, although transfer pricing-based structures (Archetype 1) may or may not entail direct investment exposure to hubs, financing schemes (Archetype 2) typically leverage

FDI links to create a *direct channel* for profits to easily reach offshore locations.

1. Exposure of developing economies to corporate investments from offshore hubs

Tax avoidance practices by MNEs are a global issue relevant to all countries: the exposure to investments from offshore hubs is broadly similar for developing and developed countries. However, profit shifting out of developing countries can have a significant negative impact on their sustainable development prospects. Developing countries are often less equipped to deal with highly complex tax avoidance practices because of resource constraints and/or lack of technical expertise.

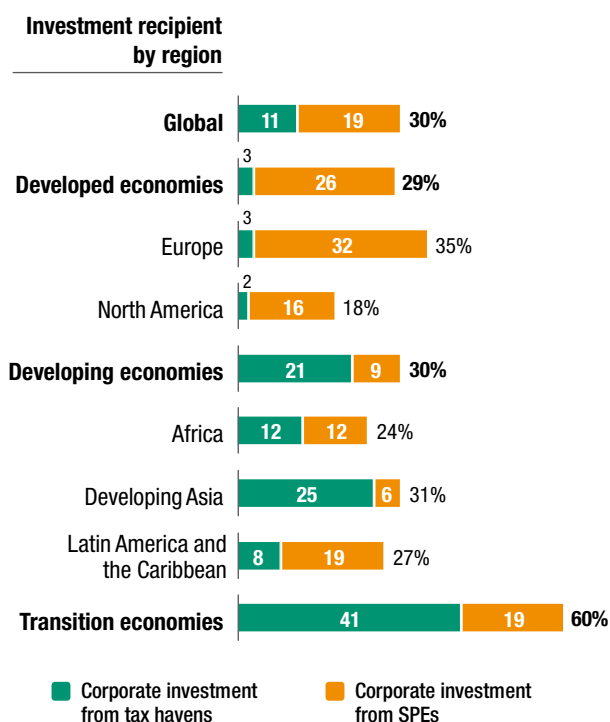
The share of inward investment stocks originating from offshore hubs provides an indication of the level of exposure of developing economies to BEPS practices. Figure V.16 on the next page shows the share of investment from offshore hubs (tax havens and SPEs) in total productive investment into non-OFC countries across different regions. The shares for developing and developed regions are substantially aligned, at around 30 per cent of total investment stock.

While the *scale* of the exposure is similar, the relative weight of tax havens and SPEs differs between developed and developing countries, with tax havens much more relevant for developing countries (at two thirds of total offshore hub exposure against only one tenth for developed economies). Regional patterns reflect the fact that specific jurisdictions tend to act as preferential investment hubs for their entire region. For developed economies, in particular for Europe, SPEs in Luxembourg and the Netherlands cover the lion's share. For developing economies the picture is more differentiated. Latin America and the Caribbean also receive a significant share of investment from Dutch SPEs. However, investment in Africa heavily relies on Mauritius, while the British Virgin Islands represent the reference offshore hub for investment in Asia. Finally, the picture for transition economies is skewed by very large investment from Cyprus to the Russian Federation.

Figure V.16.

Exposure to investments from offshore investment hubs, by region, 2012

Share of corporate investment stock from offshore hubs (Per cent)



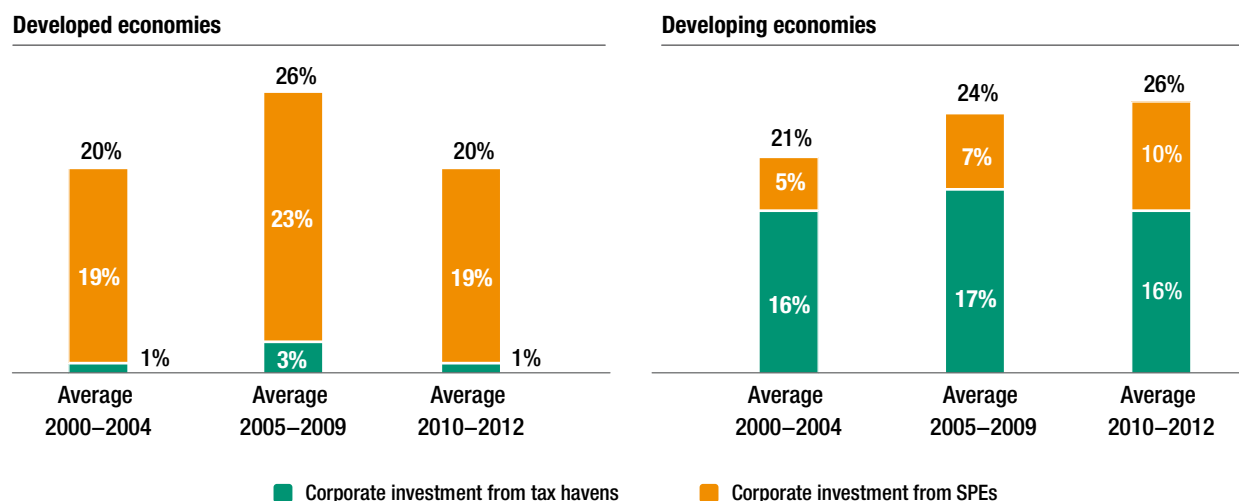
Source: UNCTAD estimates based on IMF Coordinated Direct Investment Survey 2012 and 2011; central banks for SPE investments.
 Note: The set of recipient countries includes only non-OFCs. Analysis based on the Offshore Investment Matrix, one-sided perspective. See annex II for further details.

The share of investment in Africa from offshore hubs, at 24 per cent, is lower than in other developing regions. This seems in contrast with other empirical evidence and studies suggesting that Africa faces more severe tax avoidance issues. Africa may face tax avoidance practices that do not require direct investment links to offshore hubs. Also, the average for the continent disguises tax avoidance issues in individual countries – especially the poorest countries, which weigh less in the aggregate picture. Furthermore, the perception of low MNE fiscal contributions in Africa may also be due to high levels of tax competition in individual countries resulting in low effective tax rates, rather than erosion of the tax base.²⁴

While the analysis based on the Offshore Investment Matrix, which is based on stocks, shows a snapshot of the current situation, a look at offshore links in investment flows reveals how exposure to hubs has evolved over time. This perspective highlights a negative trend for developing economies. It shows that their exposure to investments from offshore hubs is on the rise, while that in developed countries has started shrinking in recent years. In particular, although historically developing economies have been more vulnerable to investments from tax havens (as the stock analysis confirms), between 2000 and 2012, the share of inflows from SPEs steadily increased and in fact doubled (figure V.17).

Figure V.17.

Evolution of exposure to offshore investment hubs, by level of development
 Share of corporate investment flows from offshore hubs, multiyear averages (Per cent)



Source: UNCTAD FDI database; national statistics; UNCTAD estimates.
 Note: See figure V.12, also based on flows.

2. Tax revenue losses for developing economies from hub-based tax avoidance schemes

Tax avoidance practices are responsible for a significant leakage of development financing resources. An estimated \$100 billion annual tax revenue loss for developing countries is related to inward investment stocks directly linked to offshore investment hubs. There is a clear relationship between the share of offshore investment in host countries' inward FDI stock and the reported (taxable) rate of return on FDI. The more investment is routed through offshore hubs, the less taxable profits accrue. On average, across developing economies, every 10 percentage points of offshore investment is associated with a 1 percentage point lower rate of return. The average effects disguise country-specific impacts.

The quantification of profit shifting is a challenging exercise. First, tax avoidance options can be numerous. MNEs employ highly sophisticated and creative combinations of individual tax avoidance levers. Second, by the nature of the phenomenon, the available data and information is limited. The profits shifted to offshore locations are difficult to track as they typically do not appear in any official reporting: not, obviously, in the financial reporting of the foreign affiliates where the value is generated and not in that of the foreign affiliates to which it is shifted due to often lax reporting requirements. Given the complexity of the issue, studies aim to quantify specific aspects of corporate profit shifting rather than attempt a holistic approach. The effort is still valuable, as integrating the different approaches provides an order of magnitude of the losses caused by international corporate tax avoidance.

Annex II provides an overview of the main approaches developed for estimating profit shifting and tax revenue losses due to cross-border corporate tax avoidance. The FDI-driven approach used in this section stands at the intersection of some of those approaches.

The methodology proposed builds on the assumption of a negative relationship at the country level between the share of inward investment stock from offshore hubs and the rate of return on the total inward FDI stock. The underlying assumption is that the portion of income generated by FDI from offshore hubs is subject to profit shifting, with the effect of artificially deflating

the average rate of return on foreign investments (computed as the ratio between return on investment and inward investment stock). Thus, all things being equal, the higher the share of inward investment stocks from offshore hubs, the lower the rate of return.

The relationship is supported by country data that confirm a negative and significant linear relationship between the two variables. To capture the full impact of exposure to offshore hubs on investment profitability, and to ensure greater statistical validity of the relationship identified between offshore hub investment links and rates of return on investment, the econometric analysis is based on a greater number of offshore investment hubs than employed in section B. Full details on the different options are described in annex II.

Econometric analysis suggests that on average, across developing economies, an additional 10 per cent share of inward investment stock originating from offshore investment hubs is associated with a decrease in the rate of return of 1 to 1.5 percentage points (figure V.18 illustrates this relationship).

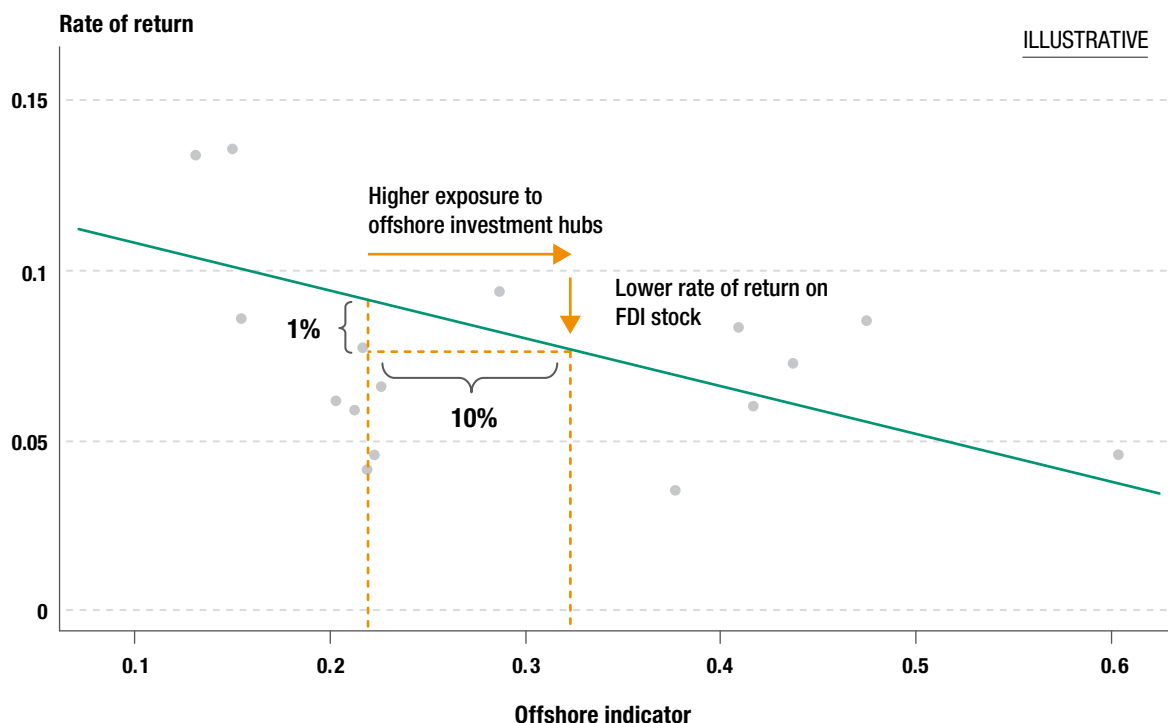
Although it is challenging to irrefutably prove a direct causal relationship between exposure to offshore hubs and reduced profitability of FDI,²⁵ this analysis provides some empirical underpinning to widespread evidence that MNEs leverage direct investment links to offshore investment hubs to enable profit-shifting practices that ultimately result in artificially low FDI income. More importantly, the quantification of the responsiveness of the rate of return to offshore hub exposure allows a *simulation* of the potential impact of these practices on tax revenues.

Once a significant relationship between the exposure to offshore hubs (*Offshore Indicator* in figure V.18) and the rate of return of the FDI income (*Rate of Return* in the figure) has been established, the tax revenue losses can be calculated through appropriate assumptions on the *profitability gap* (how much FDI income is missing due to investments from offshore investment hubs) and on the average corporate tax rate.

UNCTAD's simulation indicates that the amount of corporate profits shifted from developing economies is about \$450 billion – implying, at a weighted average effective tax rate across developing countries at 20 per cent, annual tax revenue losses of some \$90 billion. Annex II shows the parameters of the simulation and the outcomes; it includes a sensitivity analysis employing

Figure V.18.

Illustration of the relationship between the share of inward investment from offshore investment hubs and the rate of return on inward investment



Source: UNCTAD analysis based on data from the IMF Balance of Payments database and IMF Coordinated Direct Investment Survey.

Note: Scatterplot representing the relationship between offshore hub exposure (*Offshore Indicator*) and rate of return on investment stock (*Rate of Return*) for developing countries. "Conservative" case with beta coefficient at -10 per cent. The fitted line is merely illustrative and does not reflect the econometric modelling behind the estimation of the beta coefficient (the econometrics rely on a larger sample of data points, including four years, and accounts for regional fixed effects and time fixed effects; see annex II for details).

two formulations of the dependent variable (total rate of return on FDI income versus rate of return on the equity component of the FDI income) and two definitions of tax rates (effective tax rate versus statutory tax rate), with results ranging from \$70 billion to \$120 billion.

Notably, the negative relationship between the exposure to offshore investment hubs and the rate of return on FDI also holds (and remains statistically significant) for developed economies. However, its relative impact on profit shifting and tax revenue losses is proportionally smaller. This is due to a number of reasons, including the lower responsiveness of the rate of return to offshore exposure; in the case of developed economies, an additional 10 per cent share of exposure to offshore investment hubs corresponds to a decrease in the rate of return of 0.5 to 1.0 percentage point.²⁶ As a result, despite the larger size of developed-country economies, the simulation of tax revenue losses resulting from direct offshore

investment links for developed countries yields an estimate similar to that of developing countries, in the order of \$100 billion.

The profit shifting and tax revenue losses estimated here are mostly confined to those associated with tax avoidance schemes that exploit a direct investment relationship through equity or debt. Financing schemes (Archetype 2) are the most obvious example, but other schemes also rely on offshore hubs and financing schemes cannot account for the entirety of the estimated revenue loss.

Trade mispricing does not require a direct investment link: MNEs can shift profits between any two affiliates based in jurisdictions with different tax rates. Especially in the context of the digitalized economy, a significant share of transfer pricing practices exploits schemes similar to Archetype 1 – intangibles-based transfer pricing schemes. Although these schemes also involve

offshore hubs, they do not necessarily appear in host-country FDI inflows; it is enough that the corporate network includes an affiliate based in an offshore location, even if the investment to the particular host country is not channelled through it. (Figure V.19 illustrates two approaches to estimating profit shifting and revenue losses).

Therefore, the results presented here do not necessarily capture the full extent of MNE tax avoidance. They complement findings from other relevant studies focusing on the revenue losses for developing economies generated by corporate trade mispricing schemes, such as Christian Aid (2008) (\$120 billion–\$160 billion). It is important to note that the different types of tax avoidance schemes in practice are often used in combination and generally hard to disentangle. The different methods for the calculation

of revenue losses therefore provide only alternative approaches and arrive at overlapping estimates.

Leaving aside the estimates for overall government revenue losses, the *Offshore Indicator* presented here provides intrinsic value to policymakers as a “signal indicator” for BEPS, and as a rule-of-thumb method for country-level BEPS impact.²⁷

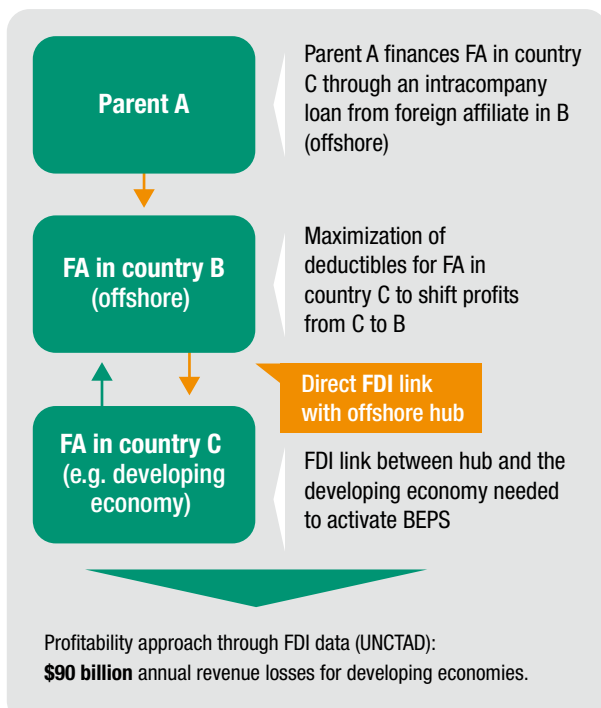
Thus, even based only on the analysis presented here and disregarding potentially significant additional revenue losses from tax avoidance schemes not dependent on direct investment links with offshore hubs, revenue leakage due to tax avoidance practices is substantial. Recovering some or all of these losses could significantly contribute to domestic resource mobilization in developing countries.

Figure V.19. Two approaches to estimating profit shifting compared

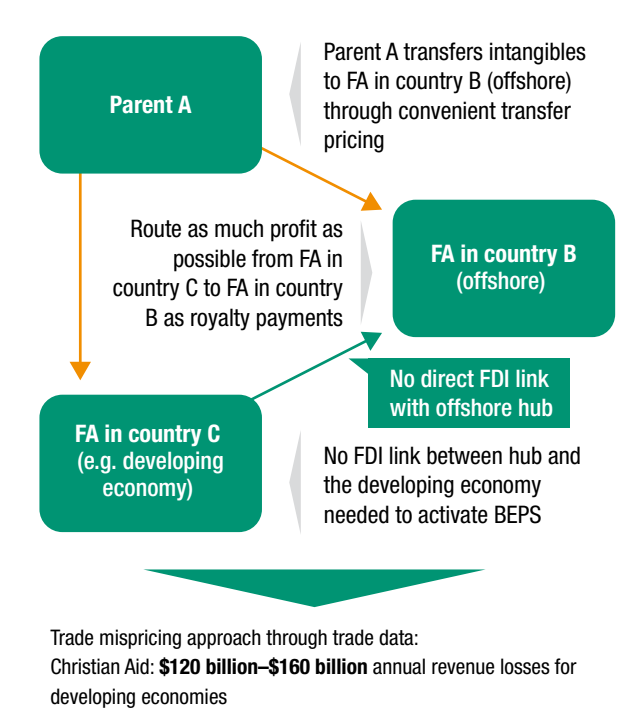
→ Income flow → Investment flow ■ Focus

ILLUSTRATIVE, SIMPLIFIED

Direct FDI link with offshore hub
Example: Financing scheme (Archetype 2)



No direct FDI link with offshore hub
Example: Transfer pricing scheme (Archetype 1)



Source: UNCTAD.

In addition, losses caused by MNE tax avoidance practices are not the only form of revenue leakage for governments. As noted in the introduction, an additional form of “slippage” is caused by fiscal incentives actively provided by governments to attract investment. Estimates from external sources – e.g. ActionAid²⁸ – reach as high as \$140 billion, although further empirical investigation, using firm-level data, is needed to better qualify the magnitude of the phenomenon.

The direct investment present in developing countries does contribute to government revenues. Section A

estimated the total contribution of foreign affiliates at some \$730 billion. Between a quarter and one third of that amount relates to corporate income taxes, which is the part mostly affected by BEPS practices. The remainder relates to other revenues, especially royalties on natural resources, and other taxes, especially those on international transactions.

Finally, attracting new investment in productive capacity and infrastructure in developing countries remains important for their sustainable development prospects.

D. TAX AND INVESTMENT POLICYMAKING: A PROPOSAL FOR GREATER COHERENCE

Tax avoidance practices by MNEs lead to loss of revenue for governments in both host and home countries of investors and to basic issues of fairness in the distribution of tax revenues between jurisdictions that must be addressed. In tackling tax avoidance, it is important to take into account the overall contribution to government revenues by MNEs and the existing tax base, as well as new productive investments by MNEs and the future tax base.

The degree to which MNEs engage in tax avoidance varies by industry and home country (among other factors), but tax avoidance practices are widespread. They cause significant tax revenue losses worldwide – in both host and home countries of international investors. Not only do they cause economic and financial damage to countries, they also raise a basic issue of *fairness*. In almost all cases, the shift in profits through the use of offshore investment hubs does not reflect actual business operations (i.e. the profits reported and taxes paid in a jurisdiction are disproportionate to the activities that take place there). The shifting of profits between jurisdictions results in an unfair distribution of tax revenues between jurisdictions.

The practice is especially unfair to developing countries that face certain tax related challenges.

- *Limited tax collection capabilities.* Accurately identifying tax planning practices requires an analysis of global operations for individual MNEs,

an unrealistic task for most countries, and especially developing ones. There is a clear case for technical assistance to developing-country tax authorities.

- *Greater reliance on tax revenues from corporate investors.* Developing economies tend to rely relatively more on tax revenues from a smaller number of large corporations. In India, 41 of the largest companies contribute just over 16 per cent of all corporate tax receipts and almost 5 per cent of the government’s total tax receipts. In South Africa, close to 24 per cent of all corporate tax receipts, approximately 6 per cent of total government tax receipts, is contributed by 35 of the biggest companies.²⁹
- *Growing exposure to harmful tax practices and tax avoidance by MNEs.* Developing countries have seen the share of investment stock originating from offshore locations increase in the last decade. The share of their investments from tax havens was already higher than in developed countries, and the share originating from SPEs is rapidly catching up.

Furthermore, at the business level, the low taxes paid and higher net after-tax profits can provide MNEs with an unfair advantage compared with domestic firms. This directly impacts market competition and suppresses the survival and growth of the small and medium-sized businesses that are vital for development. (In fact, the

BEPS project is not driven by revenue considerations alone, but also by the need to reduce distortions between MNEs and domestic companies, and between those MNEs prepared to engage in aggressive tax planning and those that are not – levelling the playing field.)

At the same time, it is fair to note that tax avoidance (as opposed to tax evasion) is not *per se* illegal – although often there is no “bright line”.³⁰ A full perspective on corporate behaviour warrants these observations:

- Corporate representatives have in the past often used their obligation towards shareholders to manage finances efficiently as a shield. More recently, many MNEs are increasingly acknowledging a wider set of obligations and corporate social responsibilities (CSR) and, more importantly, recognizing reputational risks, leading them to engage in more open dialogue with tax authorities.³¹ They are also recognizing that aggressive tax planning can lead to greater fluctuation of effective tax rates, and that it increases the risk of challenges by tax authorities, with associated financial liabilities.
- There is an intense ongoing debate, at the level of basic taxation principles, on the fairness of some taxes, especially withholding taxes, which are normally levied on gross fees or royalties and which can have effects equivalent to double taxation, thus inducing MNEs to engage in some avoidance practices.
- The BEPS debate focuses largely on corporate income tax (and a few other taxes) yet MNEs pay many other taxes, including taxes on labour, assets, use of resources, indirect taxes, levies and duties. As demonstrated in the first section of this chapter, in developing countries the direct and induced fiscal contributions of MNEs constitute a relatively high share of total government revenues.

These observations do not diminish the clear imperative to tackle tax avoidance practices and to ensure that MNEs “pay the right amount of tax, at the right time, and in the right place”. But they provide a broader context for the actions required to do so, taking into consideration the full contribution that MNEs make to economic growth and development, as well as to government revenues, and taking into account the need for countries worldwide, and especially

developing economies, to attract new investment, especially in productive capacities and infrastructure.³²

1. The tax-investment policy link and the need for a synergistic approach

While taking action against tax avoidance is imperative and urgent, including to meet the financing needs of the post-2015 agenda, the risk of negative effects on investment flows, especially to developing countries, must also be considered carefully. Insufficiently calibrated measures may deter necessary investment for development that might otherwise have taken place. Offshore investment hubs have come to play a systemic role in international investment flows: they are part of the global FDI financing infrastructure. Measures at the international level that might affect the investment facilitation role of these hubs, or that might affect key investment facilitation levers (such as tax treaties), need to take into account the potential impact on global investment and incorporate an investment policy perspective.

The investment data and the results of the analyses in this chapter show the massive and still growing use of offshore investment hubs by MNEs. As a result of growing international scrutiny, a number of hubs, and especially SPE jurisdictions, are becoming more aware of their role in international investment schemes and the potential negative effects on other jurisdictions, and are taking steps to address the situation. There is increasing cooperation, transparency and exchange of information. SPE jurisdictions are also gradually tightening requirements related to substance, or including stronger anti-abuse and denial of benefits clauses in their tax treaties. The Netherlands, for example, has offered its treaty partners the option to renegotiate existing treaties in order to include anti-abuse measures. Ireland is proposing amendments to tax residence rules to prevent “stateless” entities.

Moreover, while some cases can be described as harmful tax competition and “beggar-thy-neighbour” policies, underlining the need for concerted action, the role of offshore hubs in global investment cannot be explained and addressed only in terms of the characteristics and “responsibilities” of individual hub jurisdictions. The scale of the phenomenon clearly indicates that it is a *systemic issue*; i.e. offshore investment hubs play a systemic role in the current international investment environment. They

have become, in the current environment, standard and widely adopted tools for MNE tax and financial optimization, used by all competitors on a level playing field for MNEs, if not for domestic firms. Their systemic nature is clear when considering the fact that they are even used at times by development finance institutions – although, for example, the World Bank and the EBRD have developed a set of internal guidelines to ensure they are used responsibly.

Responsibility for the widespread use (and abuse) of hub-based corporate structures and tax avoidance schemes by MNEs should be widely shared. Home countries of investors often do not have effective legislation in place to prevent the use of hub-based structures or even unintentionally encourage the use of such structures by their MNEs. The “tick-the-box” practice applied in United States CFC (controlled foreign company) legislation is often pointed out as facilitating the use of umbrella entities based in favourable locations. Host countries are often complicit as well, as their focus is on attracting investment, if necessary at the cost of engaging in harmful tax competition.³³ A degree of tolerance for tax avoidance schemes by MNEs may have been considered by some countries as a way to reduce the visible component of such tax competition.

The acknowledgement of the systemic nature of the issue carries two important consequences with critical implications for policymaking. First, the past “*naming and shaming*” approach targeting offshore investment hubs may have been too restrictive, as it left untouched many of the largest hub jurisdictions. Second, any measures aimed at limiting the role of offshore hubs in order to counter tax avoidance and profit shifting should consider the potential impact on global investment.

Policy action aimed at reducing the use of offshore locations as investment hubs by MNEs must start from the basic questions of what makes offshore hubs attractive and what drives their outsized role in global investment. Offshore hubs, in particular SPE jurisdictions, are attractive as conduits for investment because they often provide large networks of tax treaties and investment protection treaties. In their domestic legislation they provide low (or sometimes negotiated) tax rates; their company law allows for the set-up of legal entities that are useful in international investment structures and tax schemes; and they offer a favourable business climate and other locational

advantages. Many of these features are not exclusive to these jurisdictions. They are already offered by an increasing number of other countries, motivated often by a level of tax competition. Any policy action addressing offshore hubs must therefore be of a *systemic nature*, not aimed at individual jurisdictions or a small group of countries, because corporate structures will adapt to new realities and find alternative conduits, and investment flows will take new routes to continue exploiting regulatory arbitrage opportunities.

Some of the uses of offshore investment hubs and offshore vehicles by international investors are not motivated primarily by tax considerations. For example, in mergers or joint ventures between partners from different countries with different legal and tax systems, offshore hubs may provide an attractive neutral location for the entity. They can also help firms from countries with weak institutions set up international businesses more easily and gain access to international capital markets and legal systems (a key driver of the phenomenon of round-tripping FDI).³⁴ Lower transaction costs and economies of scale also likely play a role: once a vehicle has been set up to manage an MNE's overseas holdings, whether actively or purely administratively, it is easier to route any new investments or reinvestments through the same vehicle.

Whether for tax avoidance or other purposes, it is the reality today that offshore investment hubs are playing a facilitating role in international investment. Diminishing that role is likely to have two types of effects on global investment flows:

- (i) Investments will take a *different route* from their origin or home country to their destination or host country. Existing investments will be re-routed, leading to a likely amplified initial impact of any policy action. Assuming effective policy action, investments should take a more direct route, leading to clearer investment links between host countries and countries of the ultimate beneficial owners of the investment.
- (ii) *Overall international investment levels may be reduced.* Higher transaction costs could make some investments less attractive, and higher taxes on international operations could cause the after-tax returns of some investments to drop below investor hurdle rates (the rate of return below which they will not invest).

Higher transaction costs and higher taxes on international operations could diminish overall investment levels at a time when such investment is sorely needed for economic growth and development.

On the one hand, where investments are desirable for development or other public policy purposes but unattractive for international investors, it could be argued that artificially increasing investor returns through tolerance of tax avoidance is the wrong tool and would lead to an incorrect distribution of the costs of public policy objectives. Direct support to such investments, or public-private partnerships to share risks and change the risk-return picture, would be more appropriate.

On the other hand, policymakers engaged in international discussions on BEPS would do well to assess not only the impact on the level and distribution of fiscal revenues of any proposed intervention, but also the impact on investment. The Offshore Investment Matrix is a helpful tool to start such an assessment, as it provides insights into the share of investments from and to countries affected by offshore hubs, and indications on the relative importance of archetypal schemes.

2. Towards guidelines for Coherent International Tax and Investment Policies

Coherent international tax and investment policies should protect the government revenue base and promote investment. A set of guidelines may help realize the synergies between investment policy and initiatives to counter tax avoidance. Key objectives of the guidelines proposed for discussion in this section include: removing aggressive tax planning opportunities as investment promotion levers; considering the potential impact on investment of anti-avoidance measures; taking a partnership approach in recognition of shared responsibilities between investor 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.

Recognizing the growing significance of tax avoidance by MNEs, the international community – policymakers in the G20 and beyond, international organizations such as the OECD, the World Bank, the IMF and the United Nations, NGOs and business itself – is engaged in debate and working on concrete initiatives

to counter the phenomenon. The focus of attention is largely on tax policy, accounting rules and company law, and on initiatives to improve information exchange and to increase pressure on tax havens. However, given the fundamental role of investment in building the corporate structures that enable tax avoidance, investment policy should form an integral part of any solution. Conversely, any policy initiative tackling tax avoidance by international investors is likely to affect national and international investment policies.

In considering the interdependence and potential synergies between investment policy and anti-tax-avoidance initiatives, policymakers at both the national and international levels may be helped by a set of guidelines for synergistic international tax and investment policies. These guidelines may be considered design criteria for any action by the UN and/or G20, and common-sense suggestions for national investment policymakers and tax authorities.

The policy guidance for coherent international tax and investment policies proposed below is based on the following three *fundamental principles*.

- *Promoting sustainable development.* A core objective of both international tax and investment policies is financing sustainable development. Investment policies promote private investment, and tax policies enable public investment in sustainable development.
- *Tackling tax avoidance.* MNEs should pay tax where economic activity takes place and value is created. Undue distortions should be minimized to ensure a fair distribution of revenues across countries and a level playing field for domestic and foreign firms.
- *Facilitating productive investment.* The international tax framework should protect the tax base and ensure fair sharing of the tax base among jurisdictions, and promote future investment for development.

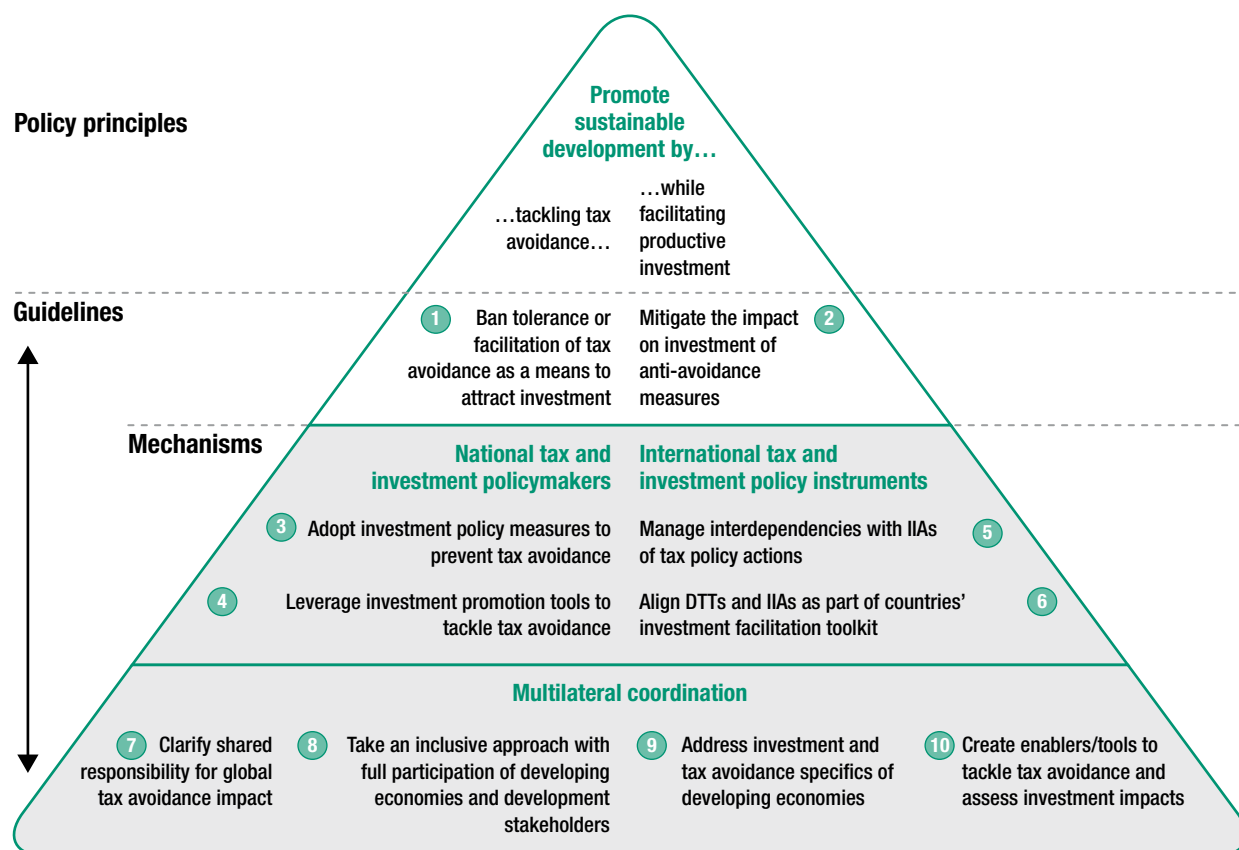
In addition, the guidelines are structured around the following key mechanisms for action:

- Action through national tax and investment policymakers.
- Action through international tax and investment policy architectures and instruments.
- Action through multilateral coordination.

Figure V.20 illustrates the concept, and the guidelines are further elaborated in the subsequent numbered text.

Figure V.20.

Guidelines for Coherent International Tax and Investment Policies



Source: UNCTAD.

Possible guidelines for Coherent International Tax and Investment Policies

1. Tolerance or facilitation of tax avoidance should not be considered an instrument either to attract inward investment or to support the competitiveness of multinational enterprises (MNEs) abroad.

Where countries wish to provide fiscal advantages to attract investors or to support investment overseas, such advantages should be extended through appropriately designed and administered incentives schemes – which should be sector specific, time-bound, transparent and conditional (e.g. on sustainable development contributions), within the boundaries of existing international commitments. See also box V.4 (on the next page) on the role of incentives.

Similarly, where countries feel compelled to attract specific investments to pursue public policy objectives,

increasing investor returns through tolerance or facilitation of tax avoidance will tend to lead to an incorrect distribution of costs; if any support is required (which must be carefully evaluated), direct support to such investments or risk-sharing arrangements would be more appropriate.

2. Measures to address tax avoidance by MNEs should carefully assess the potential impact on investment for development.

Policymakers engaged in international discussions on base erosion and profit shifting (BEPS) should assess – and scenario-test – not only the impact on the level and distribution of fiscal revenues of any proposed intervention, but also the impact on investment, especially to developing countries.

Box V.4.

Is there still a role for fiscal incentives?

The importance of tax in location decisions (see box V.1) implies that fiscal incentives are an important tool to attract investment. In fact, those developing countries that have been most successful in industrial development over the past decades have made use of various forms of incentives schemes to attract the foreign investment they needed to kick-start economic activities and to bring in the necessary technology and know-how. The success of export-processing and special economic zones in those countries – forms of incentives scheme – is proof of their effectiveness.

Despite the evidence, policy advisors in international organizations have long warned against the dangers and downsides associated with incentives. Ongoing work by the IMF, OECD and WTO on incentives for the G20 adds to the negative policy advice on incentives. The World Bank's research and advisory work has long focused on the cost of incentives and on the redundancy of many schemes for attracting investment – with good reasons: many schemes have indeed been found to be inefficient and ineffective.

However, almost all the arguments against the use of incentives are based on the way incentives are granted or administered, not on incentives per se. Thus, investment authorities worldwide have continued to include incentives in their investment promotion toolbox, fully aware of the important role tax plays in investment decisions, and unwilling to renounce one of the few available tools that can help overcome specific locational disadvantages, or that can help steer investment to priority areas for growth and development.

UNCTAD's advice on incentives, in its Investment Policy Framework and in its technical assistance work (Investment Policy Reviews) is (i) to ensure that incentives schemes are based on an overall sustainable development strategy and investment priorities, and (ii) to administer incentives in such a way as to minimize and mitigate the risks of inefficiency and ineffectiveness, as well as the risk of administrative improprieties.

Key to maximizing the *strategic value of incentives* is focusing schemes on priority activities for development and on underdeveloped regions, and associating them with sustainable development impacts. These may include economic impacts, such as employment generation, training and capacity building, and technology and know-how transfer; social impacts, such as better availability and accessibility of services, the advancement of disadvantaged groups in society, or food security; and environmental impacts, such as the reduction of emissions or the generation of renewable energy.

It is important to tailor schemes to the needs of specific economic activities and associated risk-return profiles. For example, R&D-intensive activities display different profiles of capital investment and payback over time than labour-intensive activities; fiscal incentives schemes must be tailored accordingly. The same holds when schemes are reoriented towards sectors that are central to sustainable development, such as agriculture, education, health and infrastructure.

Key to ensuring the *efficiency and effectiveness of incentives schemes* is establishing clearly defined and transparent criteria and conditions, granting incentives as much as possible automatically on the basis of those criteria and conditions, and administering the process through competent authorities, preferably independent from investment promotion authorities, with the ultimate say for the ministry of finance.

Such a move away from location-based incentives schemes aimed purely at increasing the competitiveness of a location to schemes aimed at advancing sustainable development, and adherence to common-sense good practices for the administration of incentives schemes go a long way towards ensuring consistency with WTO rules on subsidies. The WTO rules on subsidies and countervailing measures, and the gradual expiry of exceptions, have somewhat blunted the incentive tool for developing countries, making it less suitable as an instrument of industrial development (at least for export-oriented industrial development). But as an instrument for the promotion of sustainable development, and for the attraction of investment in the Sustainable Development Goals, their relevance will increase (see *WIR14*).

Source: UNCTAD.

Policy measures to tackle international tax avoidance must inevitably address the role played by offshore financial centres (OFCs). They have to mitigate the harmful tax avoidance effects of global investment hubs, but be mindful of the investment facilitation role of hubs to avoid disruptions of investment flows, especially to developing countries. Where measures might diminish the facilitation role of hubs,

policymakers might consider alternative investment facilitation measures.

A formally agreed list of acceptable uses of offshore investment hubs – e.g. as neutral ground for cross-border mergers or joint ventures – could be a starting point for international action on hubs (see also *WIR13*); policymakers should consider objectively whether tax benefits are an essential ingredient for such acceptable

applications, considering their negative side-effects and potential to escalate into harmful tax competition. In considering these measures, the international community should also take into account the potential economic impact of tax avoidance countermeasures on some developing OFCs that have adopted development strategies based on financial services.

3. National investment policymakers should consider options at the entry and establishment levels to prevent tax avoidance.

Where entry and establishment of investors is subject to approval, investment authorities could require information from prospective investors that would attest to the responsible fiscal behaviour of investors and facilitate tax collection on future revenue streams, such as disclosure of financial information and planning, and country-by-country reporting, while respecting confidential business information.

Investment authorities may even apply (within the constraints posed by international commitments and standards) stricter tax compliance or transparency conditions and rules for entry and establishment. This could be feasible in particular in a number of specific situations, e.g. privatization of state assets, concession in extractive industries, or investments related to government procurement.

Promoting adherence to corporate social responsibility (CSR) and governance standards may also be an effective tool to foster good taxpayer behaviour and transparent reporting on fiscal contributions.

4. Investment promotion and facilitation options and constructive relationship management with investors can be leveraged to reduce the motivation and opportunity for tax avoidance.

Foreign direct investment (FDI) incentives schemes should be designed and structured in such a way that they do not provide additional avenues for tax avoidance. They should not create an additional low-tax location in MNE corporate structures. If fiscal incentives are provided, they should be specific and time-bound, and ideally geared towards promoting investment in sustainable development.

Conversely, it may be possible to design and administer some fiscal incentives schemes in such a way that they remove the motivation to shift profits. For example, where tax breaks are given they could be provided for earnings

reinvested in productive assets; tax incentives could focus on capital goods (e.g. rollover relief). Incentives could also be made conditional upon pre-defined or agreed tax behaviour and on disclosure criteria.

Tax incentives and award processes, if applied, should be made more transparent, integrated into the normal budgetary process, and subject to greater accountability. Investment authorities should coordinate with tax authorities, promote good taxpayer service and foster constructive and transparent dialogue between tax authorities and taxpayers.

5. Any national or international action to tackle tax avoidance should consider interdependencies with international investment agreements (IIAs).

The interaction between international tax policy and IIAs is evident from the fact that the value proposition of the major global investment hubs that are at the heart of many tax avoidance schemes relies not only on their domestic company law and tax rules and on extensive networks of double taxation treaties (DTTs), but also on equally extensive – and often matching – networks of investment protection treaties (IIAs).

There is interaction between international tax policies (and DTTs) on the one hand and IIAs on the other. For example, the dispute settlement mechanism of bilateral investment protection treaties (BITs) has been used for tax disputes. More than 40 ISDS cases to date have involved tax-related issues.

As tax avoidance countermeasures can be interpreted as a change for the worse for investors, reducing the value of the investment, or be applied selectively on foreign investors, IIAs may pose limits on countries' right to regulate. Therefore, in negotiating IIAs, policymakers may wish to safeguard policy space on tax issues and possibly strengthen denial of benefits provisions. Beyond avoiding conflicting effects between international tax policies and IIAs, policymakers could consider how the two could mutually reinforce each other (see Epilogue).

6. IIAs and double taxation treaties (DTTs) are both part of countries' investment facilitation toolkit; these instruments should be aligned.

At the strategic level, just as countries need to consider whether and how to engage in IIAs, they need to apply the same considerations to DTTs and

to specific provisions in DTTs. At the substantive level, IIAs and DTTs have not evolved on the basis of consistent design criteria (see box V.5). For example, it is conceivable that investors may avoid permanent establishment status as defined in DTTs but are covered under IIAs due to their generally broader definition of investment.

Policy action on DTTs to harmonize and/or consolidate the treaty regime needs to consider impacts on and from the international investment policy regime, avoid conflict between the two and make them mutually reinforcing as and where appropriate. Given the importance of regional investment flows (and the competition for investment that often occurs at regional levels), regional cooperation approaches covering tax avoidance may also be fruitful.

IIAs aim to address weaknesses in countries' regulatory and institutional environment for investment. For DTTs this is not an explicit objective (also because DTTs are equally relevant between developed economies). However, in developing countries the effect of DTTs is often to necessitate increased collection capabilities on the part of tax authorities, if only because DTTs put limits on withholding taxes, an effective collection mechanism for countries with weak collection capabilities. Therefore, both IIAs and DTTs – and efforts to reform the two systems at the international level – could be accompanied by development assistance to reduce those weaknesses (e.g. technical assistance to investment and tax authorities).

7. Policymakers should recognize the role in cross-border corporate tax avoidance played by different types of offshore investment hubs as well as by home and host countries; clarify shared responsibility; and take comprehensive action.

National and international action on offshore investment links should address both tax havens and special purpose entities (SPEs) in other countries through which significant international investments are routed. Comprehensive action is needed, as partial solutions will lead only to re-routing and alternative solutions for investors.

Cross-border corporate tax avoidance and the routing of investment through offshore hubs are systemic issues, part of the global FDI financing infrastructure. The phenomenon is not driven solely by tax rules in offshore hubs, but enabled by tax rules in home and

host countries. Policymakers in non-OFC jurisdictions should address features in their own tax rules that support or incentivize the use of offshore hubs by their own MNEs abroad or by foreign investors.

8. Tax avoidance and the lack of transparency in international financial transactions are global issues that require a multilateral approach, with adequate developing-country participation.

Effective action against tax avoidance requires international cooperation; a commitment to strengthen the United Nations committee of experts on taxation is instrumental to a full participatory approach.

International cooperation is fundamental to prevent harmful tax competition; competition to attract investment should not lead to a race to the bottom.

International cooperation is also important for the success of transparency initiatives, such as the Extractive Industries Transparency Initiative (EITI). Such initiatives should ideally not focus only on governments, but also on companies. International cooperation can help improve monitoring, auditing and accountability, and it can support institutional development and capacity-building.³⁵

Effective exchange of information between tax authorities is a fundamental part of international cooperation. It is crucial to efforts to counter tax avoidance, and to counter illicit financial transactions (information exchange should include law enforcement agencies). The effect on good governance would indirectly benefit the investment climate.

Given the growing importance of tax avoidance in developing countries, the proportionately greater impact of tax avoidance on their budgets, and their greater needs to attract international investment for development, they should be adequately represented in discussions on international action on tax avoidance – particularly the low-income countries.

9. Policymakers should consider the importance of both international investment and tax revenues for sustainable development financing, and the specific features of tax avoidance in developing countries.

Given the lower tax collection capabilities of developing countries, rulemaking at the international level should take into account transition or other special and differential treatment options, as well as technical

assistance to deal with greater complexity that may result from new anti-avoidance measures. Some tax avoidance schemes are comparatively more relevant for developing countries; some countermeasures are more difficult to implement in developing countries; and the role of incentives is often greater in developing countries, with implications for the effectiveness of some countermeasures: one size does not fit all.

DTTs often have the effect of reducing or removing an effective means to collect taxes (withholding taxes) in developing countries that may have limited alternative tax collection capabilities; international measures related to DTTs should not hurt developing countries.

10. Investment and ownership information is key to analysing tax avoidance schemes and should be prioritized, together with other tools to enable anti-avoidance measures and to foster good tax behaviour.

Measurement of BEPS is critical to designing and implementing effective anti-avoidance measures. FDI data can be an effective signalling indicator for BEPS.

Collection of FDI data at the macro level (balance of payments, at country level) should be further improved (extended) to show transit FDI through offshore hubs and matching FDI income streams.

At the micro level, transparency and disclosure of investment and ownership information is indispensable. Ultimately, full transparency can only be achieved if governments (tax authorities, financial intelligence units and other regulatory agencies) can get behind the corporate veil and behind trusts to identify ultimate beneficial owners. This would complement the move towards country-by-country reporting, which enables tax authorities to have a more global view of the operations of MNEs.

Sharing of country-by-country reporting information should effectively facilitate host-country tax collection and take into account lower collection capabilities in some developing economies. CSR and integrated reporting requirements for firms could also play a supporting role, by strengthening documentation of fiscal behaviour.

Box V.5.

IIAs and DTTs

International investment agreements (IIAs) for the protection and promotion of investment, and treaties governing the fiscal treatment of investment operations between home and host countries (DTTs) are both part of the international policy environment for investors. Together they address the risk-return profile of cross-border investments, with IIAs providing an “insurance policy” to mitigate investor risk, and DTTs protecting investor returns from fiscal erosion. They are two sides of the same coin.

The systems of IIAs and DTTs naturally developed together. As FDI became an increasingly important phenomenon in the globalizing economy, investment partner countries concluded mostly bilateral investment protection treaties (BITs) and DTTs in parallel. Both types of treaties were often negotiated between the same partner countries, simultaneously or in short succession. Where countries have both a BIT and a DTT, in around a quarter of cases the treaties entered into force in the same year; about one third within a two-year period. As a result, in countries with significant outward investment stocks and large treaty networks, and especially in investment hubs, BIT and DTT network coverage often matches.

Conversely, the piecemeal growth of both systems – BIT by BIT, DTT by DTT – has also resulted in gaps in coverage and inconsistencies in treaty substance. This is compounded by the fact that the competency for negotiating BITs and DTTs generally lies with different ministries; for BITs it tends to be national investment agencies (such as Boards of Investment) or Ministries of Trade and Industry or Foreign Affairs who lead the process, whereas with DTTs Ministries of Finance take the lead, with some expertise supplied by tax administrations.

As to *coverage*, DTTs at first glance appear to be more efficient. Although the number of DTTs and BITs is roughly similar (around 3,000 DTTs are currently in force and around 2,300 BITs), DTTs cover 90 per cent of global FDI stock while BITs cover less than 15 per cent. In part this is due to the fact that the fiscal treatment of cross-border investment is equally relevant in developed countries, while the original purpose of BITs was to provide investment protection mostly in developing countries. Looking only at developing-country FDI stock, BIT coverage increases to 30 per cent, with higher shares among the LDCs. The higher apparent coverage of DTTs also reflects the fact that investment protection and promotion issues are dealt with in a host of other agreements.

As to *substance*, inconsistencies include differences in covered investments, with the concept of permanent establishment in DTTs substantially differing from the definition of “investment” in BITs; differences in dispute settlement mechanisms, with the mutual agreement procedure in DTTs considered weaker from an investor perspective than the investor-State dispute settlement system in IIAs; and varying approaches to managing the interaction between IIAs and DTTs, with only 10 per cent of BITs excluding tax issues from their scope (although 80 per cent exclude tax issues from most-favoured-nation treatment).

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Box V.5.

IIAs and DTTs (concluded)

Both the IIA and the DTT regimes are an important part of the investment promotion and facilitation toolkit of the global economy as a whole and of individual countries. Global investment hubs tend to have relatively large treaty networks of both types, with the treaty coverage of their outward investment increasing to near 100 per cent in individual cases. Host economies in some developing regions and in transition economies rarely receive investment that is not covered by DTTs or BITs, and often both.

The treaty networks evolved in parallel and for the same overarching purpose of promoting cross-border investment in productive assets (box table V.5.1). Along the way, they have come to face similar challenges. Unintended consequences and side effects have increasingly surfaced. IIAs have led to some policymakers feeling more constrained in regulating for the public good, and they have resulted in often costly claims against host states on grounds that were not anticipated in the early development phase of IIAs. DTTs designed to avoid or to mitigate the effect of double taxation have resulted in many instances of double non-taxation, and many developing countries with weak tax collection capabilities have seen limits imposed on the use of a relatively effective tax collection mechanism (withholding taxes). In both situations, to obtain treaty benefits, investors have resorted to treaty shopping and the indirect routing of investments through conduits. About one third of global FDI stock has been routed through investment hubs before arriving at its destination.

Box table V.5.1. | Common and specific themes in IIAs and DTTs

IIA-specific themes	Shared themes	DTT-specific themes
<ul style="list-style-type: none"> • Ensure fair and equitable treatment of foreign investors • Provide for adequate compensation for expropriations • Cover the operation, expansion, management and - potentially - establishment an investment • Ensure funds can be transferred out of the host country without delay 	<ul style="list-style-type: none"> • Promote economic growth and development in contracting states by facilitating cross-border investment • Prevent discriminatory treatment of foreign investors/taxpayers and provide a level playing field • Provide more certainty to taxpayers/investors • Provide a dispute resolution mechanism 	<ul style="list-style-type: none"> • Allocate taxing rights between the contracting states • Establish methods for relief from double taxation and double non-taxation • Exchange tax information and in some cases provide assistance in tax collection • Establish treatment of certain categories of taxpayer or income

Source: UNCTAD, based on ITIC (2014).

Over time, efforts to address some of these challenges – in model treaties and in negotiations – have led to some common (or directionally similar) trends in IIAs and DTTs. In IIAs, more attention is slowly being paid to sustainable development issues. Analogously, in DTTs, clauses favouring developing countries are becoming more common; for example, countries are increasingly retaining taxing rights on services. IIA negotiators are looking for a better balance between rights and obligations. DTT negotiators are starting to balance lower withholding tax rates with more expansive definitions of permanent establishments, widening the tax base.

In both the IIA and DTT regimes, progress in dealing with challenges is held back by the large inventory of existing treaties. A significant share of global FDI stock, and especially FDI stock in developing countries, is covered by treaties that were signed more than a decade (often decades) ago. These treaties do not yet reflect the gradual changes in treaty norms that have taken place, often in favour of developing countries. Only systemic reform efforts can overcome this problem.

A useful starting point will be to bridge an existing knowledge gap: to date, the interaction between DTTs and IIAs remains largely unexamined. Experts in international taxation and international investment agreements rarely have an occasion to exchange views and learn from each other. UNCTAD will aim to provide such an occasion in its regular expert meetings.

Source: UNCTAD.

EPILOGUE

REFORMING INTERNATIONAL INVESTMENT GOVERNANCE

Investment in productive assets, infrastructure and knowledge is a necessary prerequisite and the foundation for economic growth and sustainable development in all countries. Foreign direct investment plays an important role in financing for development and in supporting progress towards the Sustainable Development Goals (SDGs). The *World Investment Report 2014* presented an action plan to bridge the SDG investment gap. It argued for a concerted push by policymakers to mobilize investment, channel it to where it is most needed and ensure its positive impacts. Part of this concerted push must be the strengthening of the regulatory policy environment for investment, by *reforming international investment governance* – the topic of this year's Report.

The international policy environment for investment is not exclusively made up of international investment agreements (IIAs). A host of related policy areas are also important, including trade, taxation, competition, and social and environment issues, as identified in UNCTAD's comprehensive Investment Policy Framework for Sustainable Development. International governance varies across these policy areas. Some have a global governance framework, some are fragmented; some are overseen by global institutions and have hard enforcement mechanisms, some are governed by soft-law standards or private initiatives.

This WIR focuses on two core areas of international investment governance that are at the center of today's debate: IIAs and international taxation. Both are the object of significant reform efforts.

In IIAs, a shared view is emerging that reform is needed and that it should be guided by the goal of harnessing IIAs for sustainable development, focusing on key reform areas and following a multilevel, systematic and inclusive approach. Chapter IV of this report offers an action menu for such reform.

In taxation, attention is focusing on coordinated action against base erosion and profit shifting (BEPS), notably in the OECD/G20 BEPS project. Chapter V of this report places the tax avoidance debate in the context of the contribution of MNEs to government revenues, estimates revenue losses associated with BEPS, and

explains the links between investment and tax and the consequent need for policy coherence.

The international investment and tax policy regimes are closely interrelated. The two have *the same ultimate objective*: promoting and facilitating cross-border investment. They have *a similar architecture*, with both made up of a "spaghetti bowl" of mostly bilateral agreements. The two systems face *similar challenges*, for example, in 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.

Reform efforts must ensure the continued effectiveness of both policy regimes to maintain confidence in and support for both. The policy imperative is to continue to facilitate cross-border productive investment and to take action against tax avoidance to support domestic resource mobilization for the pursuit of sustainable development.

Each regime will have its own specific reform priorities related to its specific area of competence. But there may be merit in greater *coherence between the two reform processes*, with better-managed interaction not only avoiding conflict between the regimes (e.g. by carving out taxation from BITs) but making them mutually supporting. The guidelines for coherent international tax and investment policies set out in chapter V are a starting point.

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 reaching financing for development targets (to be discussed at the third international conference on financing for development in Addis Ababa, in mid-July 2015), and supporting the integration in the global economy of developing countries.

To that end, the international investment and development community should, and can, eventually build a common framework for global investment cooperation. UNCTAD can facilitate such a process for the benefit of all.

Notes

- 1 The term “investment” in this chapter is used as commonly understood and refers to direct private investment in productive assets. The focus is naturally on foreign direct investment (FDI), although policy implications may occasionally extend to, or be equally relevant for, domestic investment.
- 2 For a discussion on the relevance of the composition of taxes for development, see UNCTAD’s *TDR14*.
- 3 The term “foreign affiliates” covers direct investment enterprises outside the home country of the investor in which the investor owns at least 10 per cent of voting power. It includes both branches and subsidiaries.
- 4 According to the IMF, “SPEs are autonomous legal entities, directly or indirectly wholly foreign owned, that are part of a group company, without substantial real economic links with the host economy, engaged in a variety of cross-border financial activities, which are aimed at the passing through of all types of financial and non-financial assets, liabilities and related income to third countries”.
- 5 This chapter groups tax havens and jurisdictions that offer SPEs where doing so is useful to explain the conduit nature of investment structures located there. *Tax haven* refers to small jurisdictions with economies almost entirely dedicated to offshore financial activities; typical examples are the British Virgin Islands and the Cayman Islands. In contrast, jurisdictions offering *SPEs* often have substantial real economic activity, but they also act as financial centres for MNEs owing to their favourable tax conditions and other benefits for investors. The terminology is consistent with the *WIR13* (chapter 1, section A.1.d).
- 6 These include Austria, Hungary, Luxembourg and the Netherlands, with the latter two accounting for the bulk of transit FDI discussed here. The number of jurisdictions publishing SPE investment data is currently increasing rapidly as more countries are aligning with the OECD *Benchmark Definition* (edition 4th) and IMF *Balance of Payments and International Investment Position Manual* (edition 6th). The countries used here have a long record of publishing SPE data and (especially through the Netherlands and Luxembourg) account for the bulk of global SPE investment.
- 7 Note that for the Netherlands and Luxembourg such amplified FDI patterns do not affect official FDI statistics. For these countries, UNCTAD removes flows to/from SPEs from reported inflows/outflows. This treatment of the data allows segregating the *transit* component.
- 8 This characterization was first introduced by OECD (1998), p. 23.
- 9 This list of 38 jurisdictions is a revision of the original OECD list (2000) of 41 jurisdictions meeting the four characteristics (i)–(iv) to qualify as *tax havens*. Jurisdictions included are Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey, the Isle of Man, Jersey, Liberia, Liechtenstein, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, the Netherlands Antilles, Niue, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Samoa, San Marino, Seychelles, Turks and Caicos Islands, the United States Virgin Islands and Vanuatu. More recently, the OECD has increasingly focused on transparency standards and information exchange. The 38-jurisdiction list is still published on the OECD website as “Jurisdictions Committed to Improving Transparency and Establishing Effective Exchange of Information in Tax Matters”. This list has also been referred to by other studies, including Tax Justice Network (2007), U.S. Government Accountability Office (2008) and Gravelle (2013). Note that the 38-jurisdiction list employed in this chapter differs slightly from the list of 35 tax havens used in UNCTAD’s *WIR13* (p. 36, note 4), based on a more restricted set of countries published in OECD (2000) excluding some *advance commitment jurisdictions* even if they met the tax haven criteria.
- 10 UNCTAD’s *WIR13* estimates the total amount of inflows to OFCs and conduits in 2011 at over \$700 billion, consisting of \$600 billion of inflows to the SPEs in three jurisdictions Hungary, Luxembourg and the Netherlands and \$90 billion of inflows to tax havens. Of the estimated \$700 billion, only the inflows to tax havens are included in the reported FDI statistics (but excluded from analyses in the *WIR*). Other studies that look at the phenomenon of offshore FDI include Christian Aid (2013) and ActionAid (2013).
- 11 The baseline for the calculation of the absolute values (given the shares provided by the Offshore Investment Matrix) is \$29 trillion, resulting from the sum of the total inward stock reported by UNCTAD’s *WIR13* (\$23 trillion) and the (unreported) SPE component (\$6 trillion).
- 12 Also, tax havens display inward/outward symmetry; however, in the derivation of the Offshore Investment Matrix, symmetry in the case of tax havens applies by construction (see annex II).
- 13 There may be reasons other than base erosion for injecting debt funding as opposed to equity funding. In some cases, ease of repatriation can be an additional motivation. There are generally no or minimal restrictions on the repatriation of the principal amount of debt injected, whereas in some jurisdictions difficulties may arise with respect to repatriation of equity capital.
- 14 Analysis based on UNCTAD’s bilateral FDI and IIA databases. Less than 15 per cent of non-SPE outward FDI from the Netherlands is covered by bilateral investment treaties (BITs), implying that SPE flows have a higher relative preference for BIT coverage. More than 90 per cent of all outward investment (SPE and non-SPE) is covered by DTTs, indicating that tax is the most important motivation for Netherlands SPE use. Note that for investments to developing countries alone the distinction is less clear, with BIT coverage increasing significantly.
- 15 For a recent discussion of the two types of schemes in the context of developing economies, see e.g. Fuest et al. (2013b) for transfer pricing schemes and Fuest et al. (2013a) for financing schemes.
- 16 Conceptually, there may be transfer pricing aspects in financing schemes and financing aspects in transfer pricing schemes. The defining terminology is more conventional than substantive. Empirically, often the schemes are used in combination by MNEs. Nevertheless substantive differences between the two types emerge in the mechanics of the schemes (figures V.14 and V.15) as well as in the business implications (see also table V.2).
- 17 ActionAid reports some cases (www.actionaid.org.uk/tax-justice).
- 18 In 2012 Google paid only £11.6 million of corporate income taxes on £3.4 billion of revenues generated in the United Kingdom. This practice put Google under the scrutiny of the country’s tax authority.
- 19 Action 1 of the OECD Action Plan for the G20 (OECD, 2013b) is dedicated to “Addressing the tax challenge of the digital economy”.
- 20 Recent empirical work by Dharmapala and Riedel (2013) suggests that *financial* income shifting due to debt interest payment is even more relevant than *operating* income shifting (driven by transfer pricing schemes). The work analyses how exogenous earnings shocks at the parent firm propagate across low-tax and high-tax multinational subsidiaries. The central result is that parents’ positive earnings shocks are associated with a significantly positive increase in pre-tax profits at low-tax affiliates, relative to the effect on the pre-tax profits of high-tax affiliates, signalling a profit-shifting effect. Interestingly the estimated effect is attributable primarily to the strategic use of debt across affiliates.
- 21 ActionAid (2013) proposes some case examples of harmful financing schemes perpetrated by MNEs in developing economies.
- 22 On the basis of Concord estimates, public domestic sources represent on average 30 per cent of GDP (including in addition to taxation, social security contributions and other revenues such as fines and income from property); the remaining part of domestic sources (28 per cent) consists of domestic private sector investments. Domestic taxation ranges from 15 per cent of GDP for low-income countries to 30 per cent for high-income countries. External sources at 5.4 per cent of GDP include loans (1.8 per cent), remittances (1.5 per cent), FDI (1.3 per cent), official development assistance (0.6 per cent) and others (1.5 per cent).
- 23 See Atisophon et al. (2011).

- ²⁴ Existing studies tend to capture the effect of tax competition rather than that of profit shifting. In empirical studies, individual African countries commonly exhibit low effective tax rates, in part due to the abuse of tax incentives and special regimes to attract investment. However, the effective tax rate assesses tax revenue collection against a baseline (pre-tax corporate profits) that is already depressed by profit shifting. Thus it is more suitable for addressing the impact of tax incentives (leading to cuts of the tax payments, given the taxable base) rather than of profit-shifting schemes (designed instead to erode the taxable base itself).
- ²⁵ As the relationship between offshore hub investment links and rates of return on investment holds across countries, it is not possible to exclude compositional effects of specific countries driving the results. Annex II reports the results of the analysis and discusses methodological and analytical issues, including robustness tests.
- ²⁶ In addition to a lower coefficient, there are also features of developed economies that reduce the baseline on which the simulation of the impact takes place. This has a further “mitigating” effect on the aggregate estimate of profit shifting and tax revenue losses. These issues are discussed in more detail in annex II.
- ²⁷ The *Offshore Investment Matrix* and the *Offshore Indicator* developed by UNCTAD are being considered by Working Group 2 of the OECD Fiscal Committee and the Action 11 Focus Group of the OECD/G20 BEPS Project for inclusion in the deliverable for Action 11 as signal indicators.
- ²⁸ On the basis of tax expenditure data for a sample of 20 developing countries, M. Hearson in 2013 estimated the revenue loss related to tax incentives granted on corporate income taxation at a half percentage point of GDP (0.6 per cent simple average; 0.47 per cent weighted average). Using the 2012 GDP for developing economies, at \$25.5 trillion, leads to total losses of around \$140 billion. See the ActionAid website for more details: www.actionaid.org/2013/07/tax-incentives-cost-138-billion.
- ²⁹ See PwC (2008) and PwC (2013a).
- ³⁰ The very concept of “anti-avoidance rules”, which obviously make a targeted type of avoidance illegal, blurs the definitional distinction. The distinction also does not address the possibility of retrospective measures that would change the characterization of actions over time.
- ³¹ For a discussion on the importance of constructive and transparent dialogue between tax authorities and taxpayers, see Owens (2013).
- ³² For a discussion on tax policy as an investment determinant, see Owens (2012b).
- ³³ For a discussion on positive and negative effects of tax competition, see, for example, Owens (2012a).
- ³⁴ See UNCTAD *WIR13* on FDI and offshore finance, p. 17.
- ³⁵ See also UNCTAD *TDR14* (pp. 194–195) for further recommendations specifically regarding EITI.

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