Tax Evasion and the Offshore System

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A major factor undermining tax systems in all countries is the ability of the richest people and largest corporations to dodge taxes by exploiting the tax haven and offshore secrecy system. This involves not only clearly criminal behaviour but also other ways of exploiting the legal uncertainties created by this murky system. This article aims both to outline the causes and propose some cures for this systemic problem.

The tax haven and offshore secrecy system

The modern tax haven system emerged in the 1920s, to enable wealthy families and transnational corporations (TNCs) to avoid paying taxes on income or profit, which had become an important source of government revenue to pay for war and welfare (Picciotto 1992, Zucman 2015). TNCs led in refining it from the 1950s, especially by adding the important element of offshore finance. Offshore financial centres brought in special laws strengthening banking and commercial secrecy with criminal penalties, such as the Confidential Relationships Law of 1979 in the Cayman Islands. This made the offshore tax haven and financial secrecy system easy to use also for money-laundering of the proceeds of crime and corruption. Financial liberalization from the 1970s gave easy access to this system to a much wider range of people, leading to its enormous expansion.

Lawyers, accountants, bankers and other professionals who act as facilitators have helped to devise these facilities, and then have used them to enable the owners and controllers of wealth to hide behind a veil of secrecy, to conceal shady dealings and crime, as well as to dodge taxes. In every country around the world when a scandal erupts concerning politicians, sleazy businessmen or tax dodging corporations, the trail leads through a chain of shell companies, for example in British Virgin Islands or Delaware, to bank accounts, perhaps in the Cayman Islands or Switzerland.

Offshore is not just a matter of some small palm-fringed paradise islands. It is a system or network which links the large financial centres in London, New York, Singapore or Zurich with other smaller jurisdictions, interacting to offer a range of special facilities to non-residents. It has been estimated that today around 8% of the financial wealth of individuals ($7.6 trillion) is held offshore, as well as 55% of the foreign profits of US TNCs (Zucman 2015, 3, 35). Such estimates can only be very approximate, due to the murky nature of the system itself.

Only part of these funds represents actual loss of tax to other countries, but the system has undermined government revenues of countries around the world in several ways. First, the direct revenue losses are substantial, although hard to estimate accurately. In many ways more damaging are the indirect effects. The ability of the richest individuals and corporations to escape taxation in this way foments competition between states to reduce taxes on the wealthy. It has become increasingly acceptable to consider tax as a burden, and especially a disincentive on investment. This perception is contradicted by

much evidence from the real world. Investors generally look for good infrastructure, modern communications networks and an educated workforce, which are only possible if governments are well-funded. Rich people do not need an incentive to make their wealth grow even larger. The ability of large TNCs to achieve low effective tax rates on their retained earnings has provided funds to fuel their growth, but mostly through acquisition of other businesses, often small and medium enterprises, and start-ups. Also, a large part of the retained earnings of these giant companies is used for share buy-backs (Haldane 2015, p.12), and not reinvestment. This leads to booms in share prices, which benefit their top managers whose remuneration is substantially related to those prices (Lazonick 2014). Tax avoidance by large TNCs has given them a competitive advantage over smaller domestic business, contributing to monopolization and hindering true entrepreneurship.

The ability of large corporations and the super-rich to avoid tax has increased the tax burden on immobile factors such as labour income and consumption, undermining the principles of fairness on which the legitimacy of taxation rests. Although corporate profits have generally grown as a proportion of GDP, corporate tax revenues have remained more or less on the same level in the period 1965–2014 on average in OECD countries, both as a percentage of GDP and of government revenue.[1] This has endangered the ability of all states to provide the essential public services and infrastructure on which economic development, prosperity and even civilised life depend.

Illicit financial flows and their nature

The importance of reducing, and eventually eliminating, illicit financial flows, has now been recognised in the Addis Ababa Action Agenda of the United Nations, as key to ensuring good governance, as well as contributing to the domestic resource mobilisation necessary for achieving the Sustainable Development Goals, adopted in 2015.[2] There is much debate about what should be included in the concept of illicit financial flows, but I suggest that it should include all flows making use of the offshore system:

- the concealment of the proceeds of crime or corruption;
- tax evasion;
- tax avoidance and tax planning;
- hiding wealth from public agencies, business associates, or family members.

All of these make use of the same facilities of secrecy and complexity provided by this system.

It is sometimes said that many of these activities are 'perfectly legal', and hence legitimate. However, if they are legal, there is no need to carry them out offshore. Private persons' bank accounts, financial information and other aspects of their personal affairs are generally protected in all countries by laws on confidentiality and privacy, which can only be overridden in specified circumstances, when there is a public interest. There is a network of tax treaties aimed at preventing double taxation of income from international investments, and in any case countries wishing to attract such investments generally provide inducements, not excess taxation.

Offshore is a murky world which facilitates a range of criminal, illegal, illegitimate and undesirable practices, all covered by the broad term illicit.

A distinction can be made between tax evasion, which is criminal, and avoidance, which is often described as legal. However, the line between the two is hard to draw, because it is

difficult to prove the deliberate intent needed for a criminal conviction. Also, the wealthy can pay lawyers to devise complex structures which exploit ambiguities and loopholes in the law, and to provide plausible arguments that the arrangements should be considered legal. This 'tax planning' aims to defeat the aim or purpose of a law by devising schemes to achieve the same economic result, but by different means which arguably comply with the letter of the law. As fast as legislators close up a loophole, the fertile minds of tax avoiders create a new one.

It is also hard to challenge such arrangements because of the veil of secrecy and complexity created around them. Until very recently tax authorities could not obtain information from abroad, especially from the secrecy jurisdictions – indeed many countries were reluctant to help other countries enforce their taxes.[3]

To improve transparency, some countries have introduced requirements to notify avoidance arrangements to the tax authorities. The first scheme specifically aimed at requiring reporting of cross-border tax avoidance arrangements, and for these reports to be shared between tax authorities, was put forward by the European Commission in June 2017.[4] However, a notification requirement alone is little deterrent, as the tax can remain unpaid, and may never be paid if the scheme is found to be successful. Even if a scheme is found unlawful, the work of having devised it is not necessarily illegal. To combat this, the UK in 2014 introduced a procedure to require up-front payment of the tax due for schemes considered to be unlikely to succeed, and in 2017 a procedure to penalise enablers of failed 'abusive' schemes.

Even if information can be obtained, tax authorities need substantial resources to disentangle and understand the complex structures involved, and mount a legal challenge. They are always outgunned by the army of well-paid enablers hired by the rich to protect their wealth. Hence, there is an unknown but undoubtedly large amount of tax which could have been found payable if the authorities had sufficient resources. Some of this may be due to behaviour which might be found to be criminal, the rest to the use of devices which would be found invalid or unlawful, if the authorities had sufficient resources to obtain the necessary information and to challenge them. All this activity is unlawful, and can rightly be termed illegal, even if it would be hard to prove criminality.

So both evasion and illegal avoidance fall within the concept of illicit flows. Indeed, this term also extends to activities which manage to escape the legal net but are against the public interest. This category is likely to be quite large, since international tax rules have become quite ineffective. Since the term 'illicit' is quite wide, it is important to be clear about that these flows include several components, especially when making estimates of the amounts. Nevertheless, the lines between the various categories are often very blurred.

In particular, there can be confusion due to the use of the term 'transfer mispricing' in international trade. This can occur for example if there is collusion between an importer and an exporter, who may agree to issue an invoice for a lower price than actually agreed. The difference can be paid into an offshore account, so reducing any import duties, and resulting in an illicit financial flow from the country of import. Such practices are illegal evasion, indeed usually criminal.

This is different from the problem of transfer pricing within a TNC corporate group, since such transactions take place between companies under common control, so there is no 'real' price agreed between independent parties. International tax rules allow tax authorities to adjust the income of the associated entities, to reflect what they would have been if the transactions had been between unrelated parties. However, this is a legal fiction, and

the methods used to apply it give TNCs considerable scope to shift profits to countries where they will be more lightly taxed. This avoidance is difficult to counteract, especially for tax authorities in developing countries, since it requires tax officials with considerable expertise.

Abusive transfer pricing uses similar techniques and facilities to transfer mispricing. Defeating it needs a willingness to stand up to aggressive tax avoidance practices, which also depends on the political climate. For example, in 2012 it was reported that Starbucks, since it opened in the UK in 1998, had consistently declared tax losses; despite opening 735 outlets and generating over £3 billion in coffee sales, it paid only £8.6 million in income taxes. This was apparently due mainly to the UK affiliate paying a royalty of 6% for the brand name and other rights, at the 'top end' of the permissible range (Bergin 2012). Following the publicity, the company waived some deductions so that it paid £20m in tax, and later restructured its business to pay some UK tax (Houlder 2015). Although its transfer pricing arrangements were apparently not challenged in the UK, the European Commission in 2015 found that the low tax rate of its Netherlands affiliate was a breach of EU state aid rules, requiring a repayment of €20m-€30m, which is under appeal. The UK also in 2015 introduced a Diverted Profits Tax, aimed at pressurising TNCs not to use aggressive avoidance schemes such as Starbucks's.[5]

Hence, a substantial amount of international avoidance cannot adequately be tackled under current tax rules, which have become highly dysfunctional. The line between lawful and unlawful tax avoidance is both unclear and elastic, depending on both the resources available to tax authorities, and their willingness to use them. Nevertheless, all of this uses similar techniques, involving opacity, complexity, and chains of corporate vehicles and other entities formed in convenient jurisdictions. This was seen most recently in November 2017, with the leak of documents known as the Paradise Papers. These are mostly from Appleby, a firm specialising in creating these vehicles, whose clients included both wealthy individuals and leading TNCs, including Apple, Nike, Whirlpool and Glencore (Pouchard 2017). All can rightly be regarded as coming within the term illicit.

International tax avoidance also exploits the indeterminacy of legal terms, particularly the concepts of residence for legal entities such as corporations, and of the source of income (Picciotto 2007). Loopholes are also created by divergences between the laws of different countries. For example, some laws treat a company as resident where it is managed and controlled, meaning where its directors' meetings are held. This applied in Ireland, helping many US companies to use companies formed in Ireland but treated as resident elsewhere to keep enormous profits offshore (in the case of Google, in Bermuda: see Drucker 2012). Tax advisers not only take advantage of such loopholes, often they help to create them, by lobbying pliant governments, sometimes even submitting drafts of suitable legislation.

Moreover, schemes which may not themselves be illegal can facilitate evasion. A key example is investment funds, such as hedge funds and private equity funds. The world's largest location for such funds is the Cayman Islands, which have no income tax. The only activity relating to these entities which takes place in Cayman is routine back-office work, employing a handful of people. The real decisions are made by highly-paid investment managers employed by companies in New York, London or elsewhere. Yet tax authorities in countries such as the UK and the US have accepted that the funds can be treated as resident in Cayman, and their income as sourced there (Sheppard and Sullivan 2008). Since Cayman has no income tax, the fund's trading income and capital gains are untaxed, while

the investment companies are taxed only on the fees they are paid for providing advice. More importantly, Cayman does not apply a withholding tax on distributions from such funds to investors. They should report this income for taxation in their country of residence, but many evade tax by hiding behind secrecy laws. Although the fund organisers have committed no illegality, they have enabled its investors to evade tax.

Corporate avoidance and the flaws in the system

Corporate tax avoidance is clearly only a relatively small part of the total illicit flows, and only part of those flows entails direct losses of government revenue. Nevertheless, all illicit flows use the same facilities and techniques. Indeed they were first devised for wealthy families and TNCs. Further, the growth of a culture of increasingly aggressive tax planning, and its toleration as a valid business strategy, have affected the boundaries of acceptable behaviour. The removal of incentives for TNCs to use the system could clearly be a significant step towards ending its wider damaging effects.

The creation and continuation of the tax haven and offshore secrecy system results from a fundamental flaw in the international tax rules. Designed almost a century ago, these rules were primarily aimed at international portfolio investment, dominant at that time, when individual investors bought bonds or shares in foreign companies. Hence, the primary rights to tax business profits ('active' income) were given to the country where the business was located (the source country), while returns on investment (interest, dividends, etc., or 'passive' income) should be taxed in the country of residence of the investor.

This was difficult to apply to TNCs, since it is hard to determine the appropriate level of profits of the subsidiaries or branches in different countries. Hence, tax authorities were given powers to adjust the accounts of related entities under common ownership and control. However, these powers were contradictory: while based on the understanding that the affiliates of a TNC are under unified control, the basis for adjustment was that the income of affiliates should reflect what might be expected if they were independent.

TNCs began to exploit this independent entity principle to reduce their overall tax liabilities, by creating intermediary entities in convenient jurisdictions. Such 'letter-box' entities can own assets or perform functions for which operating affiliates pay royalties, interest or fees, which can be deducted to reduce tax on their profits. This income can remain untaxed, if channelled through conduits to affiliates in zero-tax countries. Such techniques create enormous pools of low-taxed retained earnings, helping to finance the expansion of TNCs.

Tax authorities have long known these defects, but remedies require stronger coordination, which is hard to agree, so some resorted to national measures. In 1962 the US introduced rules to tax the profits of foreign subsidiaries, defined as 'controlled foreign corporations' (CFCs). But, because of resistance from US TNCs which argued that this would make them uncompetitive, the measures were limited to the 'active' income of CFCs in low-tax jurisdictions. Some other countries adopted similar rules, but in recent years they have been further weakened due to tax competition.

In 1968 the US also introduced regulations on transfer pricing, for adjustment of accounts of affiliates of TNCs. These adopted a narrow interpretation of the independent entity principle, requiring adjustments to focus on transactions and to be based on the identification of comparable prices in market transactions between unrelated entities carried out 'at arm's length'. This approach was recommended in a report by the OECD in

1979. However, it proved dysfunctional, as in practice it is difficult or impossible to find true comparables. This led the US to introduce additional transfer pricing methods, one for attributing a comparable level of profit, and a 'profit split' method, to apportion the aggregate profit from the relevant transactions (Durst and Culbertson 2003). After considerable conflict among OECD countries, these were included in the OECD Transfer Pricing Guidelines of 1995. The OECD Guidelines gradually became applied around the world, in recent years even in developing countries. Yet wherever they have been introduced they have resulted in increased conflicts and disputes, due to the ad hoc and subjective nature of the criteria to be applied (Picciotto 2017, ch. 1).

The arm's length principle has encouraged TNC tax advisers further to exploit the independent entity concept. Since the 1990s, many TNCs have restructured their operations by fragmenting different business functions (research, design, assembly, marketing, sales, distribution, and back-office activities), into global value-chains which are generally tax-driven.[6] These strategies have been greatly facilitated by the digitalization of economic activities. Countries now compete to offer tax advantages to attract the location of entities which perform supposedly high value functions. Meanwhile, payments for rights to intangibles, loan interest and service fees are used to channel substantial revenue to low-taxed affiliates, described as 'stateless' income (Kleinbard 2011).

The emergence of counter-measures

More determined attempts at internationally coordinated action have emerged due to political pressures on governments (Picciotto et al. 2017). In 1996 the G7 world leaders recognized the problem of tax competition resulting from globalization. The resulting OECD report on *Harmful Tax Competition: An Emerging Issue* (1998) identified two problems: tax havens and 'harmful preferential tax regimes'. It was soon weakened by a change in US policy, and the project refocused on obtaining information from tax havens, pursued through a laborious process of negotiating bilateral tax information exchange agreements. However, the Tax Justice Network, founded in 2003, argued from the beginning for a multilateral framework for comprehensive and automatic exchange of information.

The financial crisis of 2007–8 and the ensuing austerity measures in many countries created increased urgency. In April 2009 the G20 leaders boldly asserted that '[t]he era of banking secrecy is over', and in 2010 the US Foreign Account Tax Compliance Act (FATCA) imposed an obligation on banks to supply details to tax authorities of payments to their customers, though only for US taxpayers. In 2013 both the G8 and the G20 called for a new global standard for the exchange of information for tax purposes, and a commitment to transparency for ownership of companies. This was a qualitative shift, all the more notable for being led by the United Kingdom, which had long been criticised for protecting the large number of havens and secrecy jurisdictions that are UK dependencies.

The Common Reporting Standard (CRS) was established in 2014, with commitments to begin exchanging information automatically by 2018. So far, 101 countries have committed to implement the CRS, 54 of them in 2017, 47 by 2018. While this is a remarkable success, concerns remain about the accuracy of the CRS (Knobel & Meinzer, 2014), and about the absence of the United States from the system due to their FATCA special regime (Knobel, 2016). An even bigger challenge is the establishment of a global system of registers of the beneficial ownership of wealth.

Growing public concerns, reflected in the emergence of civil society organisations ac-

tive on tax justice, also focused on corporate tax avoidance, its links to evasion and capital flight, and their effects especially on developing countries. Tax had also come to be identified as a key issue for both governance and economic development in developing countries. Hence, both the G8 and the G20 leaders also called for reform of rules on international corporate taxation.

The G20 therefore in 2013 endorsed the OECD project on 'base erosion and profit shifting' (BEPS), which produced its reports in October 2015. Unfortunately, these were a patchwork of measures, mostly aiming to strengthen existing rules. In particular, they failed to provide clear criteria for the allocation of profit, although work on this has continued. The main achievement was the establishment of a system for country-by-country reporting by the largest TNCs, which for the first time will give tax authorities an overview of the group, details of its parts, and data on its profits, tax paid and employees in each country.

The limitations of the BEPS project outcomes were shown especially by the failure to make any recommendations under its Action 1, on the tax consequences of the digital economy. The report which was produced analysed the issues, stressing that digitalization has affected the whole economy. Indeed, as outlined above, it has exacerbated the basic problems of international tax rules based on the outdated independent entity principle. In the absence of a multilateral approach, various countries are adopting unilateral measures, including the UK's diverted profits tax emulated by Australia, and India's 'equalisation levy'. A variation of this was proposed for the EU in September 2017 by ten countries led by France.

However, it should by now be clear that what is now needed is a paradigm shift, away from the independent entity principle.

A more effective approach: unitary taxation

Since the 1980s, many commentators have advocated a reform of international tax rules based on treating TNCs as unitary firms. Such a shift was implicit in the mandate from the G20 for the BEPS project, to ensure that TNCs could be taxed 'where economic activities occur and value is created'.

Several approaches involve treating TNCs as unitary firms, and they could build on elements in existing rules. One is residence-based worldwide taxation, under which the ultimate home country of a TNC taxes its worldwide profits, but with a credit for foreign taxes paid. This would extend existing rules by treating all affiliates of a TNC as 'controlled foreign corporations'. However, it would create an incentive for TNCs to locate their parent in low-tax countries, since corporate residence is hard to define, which would exacerbate tax competition.

A second is destination-based cash-flow taxation, which bases corporate tax on sales to third parties, with deductions for investment and production costs. This reduces the competition to lower tax rates, but could be damaging to revenues of countries with relatively small consumer markets. It poses serious problems of collection from firms that have no business presence in countries where they make large sales. This could be solved by an international system of collection, but this would need close international cooperation. A version for unilateral adoption was proposed by Republicans in the US Congress, and was hotly debated in the first months of the Trump administration. It did not progress, much to the relief of other countries, since it would have violated world trade rules, triggering

trade wars, and resulted in a major appreciation of the dollar, with unpredictable consequences worldwide.

Finally, there is unitary taxation with formulary apportionment. This would apportion the consolidated world-wide profits of a TNC according to factors reflecting its real presence in each country, such as employees and sales. This could be adopted gradually, by developing the profit-split method under existing transfer pricing rules, and agreeing on factors for allocating profits appropriate for different business models.

A blueprint for such a system (the Common Consolidated Corporate Tax Base, or CCCTB) was developed by the European Commission for the EU, and approved by the European Parliament in 2011. It was not agreed by the European Council, although further technical work was done. The Commission relaunched the proposal in 2016, and it is now again under scrutiny by the Parliament. To be fully effective, however, the CCCTB should be reconceptualised, since the present version would make it hard to prevent shifting of profits outside the EU, since it applies only internally, relying on existing rules (including the arm's length principle) towards the rest of the world. A more comprehensive approach could start from the global consolidated accounts of TNCs, and apportion their worldwide profits (or losses) first between the EU and the rest of the world, and then internally.

Conclusions

Clearly the situation remains very fluid. Much has been accomplished in the past five years, certainly by comparison with the previous history. This has been substantially due to political pressures, articulated by a large and still growing civil society movement for tax justice worldwide. A particular strength of this movement has been its ability to combine the mobilization of public indignation with formulating cogent technical arguments and solutions. It remains to be seen whether this delicate balance, and the momentum it provides, can continue.

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Anmerkungen

1 OECD 2016, 108-9. In the UK, for example, the corporate tax rate has been cut from 28% in 2010 to 19% in 2017; revenue from corporate tax as a percentage of GDP has declined from 2.87% in 2011 to 2.45% in 2015, while corporate profits have jumped from £85,200m to over £100,000m. Although the UK unemployment rate roughly halved from a little over 8% to a little over 4%, labour productivity has remained stagnant, at 16% below the average of the G7 countries. This suggests that low corporate taxes have boosted profits but not stimulated investment in the UK.

2 Addis Ababa Action Agenda adopted by the UN General Assembly August 2015, UN document A/RES/69/313, especially paras. 18 and 23.

3 It was generally only possible if there was a tax treaty between the two countries, and only on request, i.e. if the person was already under suspicion. Also, many countries would not obtain information requested on behalf of another state unless they also had a tax interest in the person concerned. (This was so for the UK until 2000). The OECD made significant revisions to the information exchange provision of its model treaty in 2005, resulting from the work on tax havens discussed in section 4 below.

4 COM(2017) 335 final, 21.06.2017.

5 This raised £280m in its first full year, but is now forecast to raise £1.35b by 2019 (UK 2017, p. 6).

6 See for example the strategy adopted by the US firm Caterpillar (US Senate 2014).