Richard Murphy FCA

Tax Research LLP

June 2009

Background

The G20 Summit in London in April 2009 said in its final communiqué that:

> *We are committed to developing proposals, by end 2009, to make it easier for developing countries to secure the benefits of a new cooperative tax environment[1].*

That new environment is built around the concept of information exchange, most particularly in the form of Tax Information Exchange Agreements (TIEAs).

TIEAs are primarily designed for the exchange of information between those states and jurisdictions denied full Double Tax Agreements, usually because they are considered tax havens, or as this paper would prefer to call them, secrecy jurisdictions.

Problems with TIEAs

TIEAs incorporate an inherent problem. A request for information under a TIEA must provide or state:

(a) the identity of the person under examination or investigation;

(b) what information is sought;

(c) the tax purpose for which it is sought;

(d) the grounds for believing that the information requested is held within the jurisdiction of which request is made;

(e) to the extent known, the name and address of any person believed to be in possession of the requested information.

The reason for the low number of information requests becomes obvious immediately. There is considerable secrecy within tax havens. This is either created by law e.g. those that establish banking secrecy, or through the combination of legal entities and professional services designed to ensure

[1] http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf

that the activities of those availing themselves of those facilities are opaque. As a consequence it is, for example, exceptionally difficult to link bank accounts operated by a company in turn controlled by a trust with a particular taxpayer in another jurisdiction who may or may not be settler and / or beneficiary of that arrangement. In consequence the existence of TIEAs is immaterial: the reality is that they have little or no practical value in very many cases because the 'smoking gun' required to trigger the information request either does not exist or cannot be created to the standard required by the Tax Information Exchange Agreement process.

Corporate issues

Tax Information Exchange Agreements apply to corporate tax issues as well as those of individuals. Clearly tax havens / secrecy jurisdictions play a role in transfer mispricing, which is one of the biggest areas of corporate concern with regard to taxation where transparency is needed.

However, as one of the very rare cases of suggested transfer pricing abuse ever brought to court in Africa has shown (Unilver Kenya Ltd v Commissioners of Income Tax, Kenya Income Tax Appeal 753 of 2003) the absence of data on accounts in the destination jurisdiction of goods subject to a transfer pricing dispute was significant in the failure to determine whether profit had been shifted or not. Despite the necessary accounts being available to the same group of companies that made the appeal in this case they were not made available in court. It is highly likely that the absence of this accounting data this had a material impact on the resulting decision made by the courts in Kenya. This accounting data, if available, would provide the necessary 'smoking gun' required to initiate an information exchange request in many transfer mispricing cases.

Developing country tax issues

Development experts and those who work on related tax issues now agree that there are two main tax issues causing substantial loss of revenues to developing countries:

1. Capital flight;
2. Transfer mispricing.

It is essential that, in the first instance, the new transparency that the G20 has promised tackles these two issues. All other issues can follow on. It is emphasised that they should follow: the above two matters are the critical issues of concern that must be tackled first.

Tackling capital flight

The key concern when tackling capital flight is the illegal, disguised nature of the illicit fund flows. Ignoring transfer mispricing, the key mechanisms used for this illegal purpose are offshore financial structures such as trusts, companies and foundations.

There is at present no automatic information exchange with regard to such structures within the EU, let alone elsewhere.

The automatic information exchange arrangements which currently exist relate only to interest income paid to accounts held in individual's names. The European Union Savings Tax Directive (EUSTD) is the key example of this arrangement.

Suggestion has been made that the EUSTD should be extended to developing countries. If and when the EUSTD is extended, as the Commission plans, to trusts and companies in offshore locations this might provide some benefits if extended to developing countries but in its current form the EUSTD is unlikely to do so: it is quite unlikely that significant deposits resulting from illicit financial flows are held in individuals own names. It is relatively easy, and cheap, to set up trusts and corporate structures that can hide these flows from view.

This does, however, suggest exactly what information is required to trigger an effective information exchange request by a developing country. Those countries do not need to know the precise details of interest, profits, gains or other income accruing to offshore structures created by, owned by, or which benefit people resident within their jurisdictions to enable them to make an effective enquiry under a tax information exchange agreement. They simply need to know:

1. That such a structure exists (a bank account qualifying by itself as a structure for this purpose);
2. What each component (trust, company, or foundation) is called;
3. Who manages it;
4. Where it banks;
5. Who in their jurisdiction benefits from it.

If this data were available it is likely that almost every country in the world could and would substantially increase the number of tax information exchange requests that they might make using the proposed network of Tax Information Exchange Agreements.

What is therefore required is that this information, which the regulatory authorities of every single jurisdiction subject to IMF /FATF regulation must have available to it, be automatically exchanged with the jurisdictions in which the beneficiaries of those structures are located; that location to be identified by both the place of main residence of a beneficiary and by the country which issues them with their passport (with those places issue passports of dubious repute to be specifically blacklisted for anti-money-laundering identification purposes).

If this data were to be automatically exchanged then no further information on income need be exchanged, at least in the early stages of any information exchange process. That is because sufficient data to firstly disincentive use of such arrangements and secondly to allow information exchange requests to be made would exist. Pragmatically, that is most of what is desired of the automatic information exchange process. This does, however, have the benefit of massively reducing the risks inherent in automatic data exchange by removing entirely from that process, at least in its initial stages, any reference to specific income details.

At least in principle many developing countries should be able to make matching information exchanges in return for receipt of this data but in practice if statistical data suggested it very unlikely that illicit funds flow through a location (as opposed to originating from a location), as will be true for most developing countries, it is suggested that the exchange of information might be made optional under any automatic information exchange agreement of this sort, and that automatic data exchange in the first instance only be required from designated financial centres to designated recipient jurisdictions.

This then requires:

1. A secure delivery mechanism for distribution of the data;
2. A robust channel through which subsequent enquiry can be made by developing countries of the jurisdictions in which such structures are located as to their use, and about the quantum of the funds flowing through them.

It is obviously possible for information to be sent directly between jurisdictions in such a process of automatic information exchange. Since the data exchanged would include no financial information the file format for exchange purposes should be relatively easy to agree. The following would appear to be necessary data that must be exchanged:

1. Full name of person about whom data is being supplied and their:
    a. Date of birth;
    b. Gender;
    c. Passport number;
    d. Residential address;
    e. Tax identification number (if known);
    f. Previous names (if known).
2. Details for each structure about which information is being supplied:
    a. Name of entity;
    b. Type of entity (bank account, trust, company, foundation, etc.,);
    c. Entity registration number (if it has one);
    d. Date entity created (if known);
    e. Address at which entity considered to be located;
    f. Name of those managing the entity;
    g. Known relationship between this entity and other entities (e.g. a trust might declare companies in which it has an interest, a company might declare the trust considered to own it, a bank account might be linked to the organisation or person in whose name it is operated, etc.,);
    h. Relationship between the entity and the person for whom disclosure is made (settlor, trustee, director, enforcer, ultimate beneficiary, beneficial owner, etc.,);

The technical processes involved are relatively straightforward to resolve compared to those required to define the nature of income which may, or may not, be subject to information exchange, especially given that the problems of associating entities of the sorts noted with the 'warm human beings' who benefit from their existence have now been widely addressed for anti-money laundering purposes.

If such information could not be sent directly then the Financial Action Task Force / Board appears an obvious intermediary given its role in the anti-money land erring area, to which this data relates. The World Bank or IMF appear to be other obvious intermediary custodians of data for exchange purposes.

With this data Tax Information Exchange Agreements become meaningful: the 'smoking gun' required to make them useful would exist. There does, however, remain the problem of negotiating the necessary thousands of such exchange agreements, all of which will be remarkably similar. There appear to be two options to speed this process:

1. That each jurisdiction likely to receive information requests make available a standard Tax Information Exchange Agreement that can be agreed with any applicant, subject only to assurance that the recipient state will not abuse the data sent to it, or:
2. A multilateral Tax Information Exchange Agreement be made available.

Of the two options the former seems more realistic subject to the OECD approving the standard TIEA made available by a jurisdiction. There is no suitable multilateral agreement in operation at present.

Tackling transfer mispricing

The data required to tackle transfer mispricing could, in some cases, be secured by TIEAs. However, as is noted above, the key data required to initiate a request relates to whether profit rates vary between states suggesting that profits have been so arranged to ensure that tax is not paid in higher tax jurisdictions.

There can be no doubt that the easiest way to provide significant initial information to assess which transfer pricing cases to tackle can be provided by country-by-country reporting. This would require every MNC to declare:

1. In which countries it operates;
2. What it is called in that location;
3. What its financial performance is in every country in which it operates, including:
    - It sales, both third party and with other group companies;
    - Purchases, split in the same way;
    - Labour costs and employee numbers;
    - Financing costs split between those paid to third parties and to other group members;
    - Its pre-tax profit;
4. How much it pays in tax to the government of each country in which it is operating.

Senior tax officials in a number of countries have confirmed that this data, if available for a group, would allow them to assess more easily which companies required investigation in more depth to determine if and how transfer mispricing was taking place. The data provided by country-by-country reporting would reduce the cost of risk-appraising data, substantially increase the likelihood of the right cases being pursued and reduce the length of time enquiries take, so significantly increasing the chance of the tax yield from such activity increasing. That is why country-by-country reporting provides the necessary 'smoking gun' data for Tax Information Exchange Agreements to be meaningful as a tool to tackle transfer mispricing.

Conclusions

The recommendations made in this paper will not stop capital flight or transfer mispricing. They would however deliver the outcomes the G20 has promised. And they would do so cheaply, effectively, and at low risk for all involved with maximum likelihood that they would automatically supply the data developing countries need to ensure they can make use of the opportunities provided by new information exchange arrangements, as promised by the G20.

