Closing the European Tax Gap

A report for
Group of the Progressive Alliance of Socialists & Democrats in the European Parliament

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Contents

Summary	2
Part 1: Defining terms	6
Part 2: Estimating the scale of the problem	9
- Tax evasion	9
- Tax avoidance	16
Part 3: Tackling the problem	23
- Tax avoidance	24
- Tax evasion	69
Endnotes	94

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Summary

This report has three objectives. It:

1. explains the ways in which tax evasion occurs within and between EU member states;

2. estimates the total losses to EU Member State Treasuries arising from that evasion and tax avoidance;

3. identifies policy options, from the modest to the radical, for intensifying EU and Member State action against such abuse.

Using consistently credible sources the resulting estimate of tax evasion in the European Union is approximately €860 billion a year.

As the report notes, estimating tax avoidance, which is the other key component of the tax gap in Europe, is harder. However, an estimate that it might be €150 billion a year is made in this report.

In combination it is therefore likely that tax evasion and tax avoidance might cost the governments of the European Union member states €1 trillion a year.

These losses can only be accurately located with regard to tax evasion. Italy loses the most in Europe as a result of tax evasion. Its loss exceeds €180 billion a year. Estonia is, however, the biggest loser when the tax lost is expressed as a proportion of government spending. More than 28% of Estonia's government spending is lost to tax evasion each year.

This though is not just an individual country problem: taken together tax evasion in the EU costs more than total EU health care budgets, and if that tax evasion could be stopped total EU deficits could be repaid in just 8.8 years. In Ireland it would, admittedly be longer, taking some 23 years, but the message is a very clear one, and that is that at a time of fiscal crisis we can no longer ignore the fact that tax evasion and tax avoidance undermine the viability of the economies of Europe and have without doubt helped create the current debt crisis that threatens the well being of hundreds of millions of people across Europe for years to come.

As a result the report looks at ways to tackle both tax avoidance and tax evasion in Europe to help redress this problem. It does so in a totally new and innovative way, developed for the purpose of this report. By splitting tax avoidance and tax evasion activities into generic types it is firstly seen that some such issues are currently beyond likely policy redress within the EU. So, for example, much tax avoidance could only be stopped if there were to be a fundamental change of view on the need for the free movement of capital in Europe, or to the right to incorporation at will. Other tax avoidance measures require a fundamental change in attitude towards taxing the family unit and many more would require change only possible at the member state level and therefore beyond EU

control. That being said though the report does then develop a series of recommendations for action that build on a consistent them, relating to both tax avoidance and tax evasion that is developed within the report. This might be called the 'smoking gun' approach.

This smoking gun approach recognises that individual action against tax evaders and avoiders is never going to eliminate this problem by itself. The scale of the problem is too big for that to happen. That means that what is required is the disclosure of information either to tax authorities or on public record or within accounts that will most successfully draw attention to those tax evading and tax avoiding and so increase their risk of being found out to be doing so. The result is that this approach is designed to deter these activities.

This is not to deny that direct action has a role to paly in many cases, and a specific recommendation is made that more resources need to be allocated to tax authorities across Europe to make sure that direct action can be taken. Providing those taking such action with access to the best possible data on who is avoiding and evading is, however, vital to the cost effective success of any such campaign to collect more tax and so prevent economic meltdown in Europe. That is what these recommendations are intended to do.

As a result with regard to tax avoid the key recommendations are:

Recommendation	**Issue tackled**
Introduce country-by-country reporting	Transfer pricing, lack of transparency in group accounts, reallocation of profits to tax havens.
Introduce Common Consolidated Corporate Tax Base	Transfer pricing, reallocation of profits to tax havens.
Support general anti-avoidance principle	Sophisticated tax avoidance.
Introduce accounting reform	Requiring the disclosure of data needed to disclose transfer pricing issues, lack of appropriate date to tackle tax issues in small company accounts and disclosure of group trading.
Change corporate accounting disclosure for tax purposes	Lack of information available to tax authorities on the tax accounting of companies that lets them hide the impact of their tax avoidance from view.
Promote Codes of Conduct	The failure of professional advisers to multinational corporations and other taxpayers to disclose the tax avoidance that they undertake.

Of these issues country-by-country reporting and the Common Consolidated Corporate Tax Base offer immediate prospects for gain but since the Accounting Directive is open for debate at present there are opportunities for discussion across almost the whole of this agenda at present.

With regard to the bigger issue of tax evasion the key recommendations are:

Proposed reform	**The matter tackled**
Invest more staff in tax audits.	The cash economy.
Reform small business tax returns to provide more information on sales income.	Under-declared cash income.
Seek smoking gun data on tax evasion from other government maintained registers such as land and car registers.	The cash economy.
Police likely outlets for smuggled goods more effectively.	The criminal economy.
Upgrade the European Union Savings Tax Directive.	Suppressed data.
Extend the geographic scope of the European Union Savings Tax Directive.	Suppressed data.
Where the European Union Savings Tax Directive cannot be applied demand new forms of more limited, but cost effective, information exchange.	Suppressed data.
Require that banks disclose the opening and closing of all bank accounts whether income is paid on them or not.	Suppressed data.
Require that company registries undertake due diligence on beneficial ownership, directors, secretaries and registered addresses.	Identity disguise.
Require that registers of trusts be maintained where trusts are permitted by law.	Identity disguise.

The terms ‘suppressed data’ and ‘identity disguise’ are key to these recommendations. Suppressed data refers to a situation where a person exploits current regulation to hide information from tax authorities. The use of tax havens is an obvious example. Identity disguise refers to the alternative abuse of hiding information behind entities that the person cannot be shown to own or control. Of course the two can be combined and often are. Tackling these two issues may be key to progress at present on tax evasion.

What both agendas also incorporate is support for honest businesses that want to compete on a level playing field where abuse of the tax system plays no part in their success. As such they are strongly pro-market proposals. For too long, and too often in the name of deregulation, both the EU

and members states have promoted ideas that have undermined effective regulation and the supply of meaningful accounts so that a company can be properly appraised upon its true economic activity. This has assisted the creation of monopoly power by large companies, undermined tax revenues and led to significant tax fraud amongst smaller businesses. All destroy the effectiveness of markets and their capacity to meet the needs of the population of Europe. These reforms are designed to address those issues by holding taxpayers to account and by ensuring those who are intent on securing their profits from abusing the law have least chance of doing so. As such these recommendations to uphold and reinforce regulation are intended to deliver the fair markets to which Europe is committed whilst ensuring that taxes are paid. They do as a consequence represent a double win for Europe and that is why they should be adopted.

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Part 1: Defining terms

This paper is about illicit financial flows, whether within or between states.

Illicit is a complex term that does not have the same meaning as illegal. It is defined by the Shorter Oxford English Dictionary as meaning:

> *Not allowed; improper, irregular; unlawful; esp. not sanctioned by law, rule, or custom.*

This is the meaning given to it in this report. As such illicit financial flows are of two sorts.

The first sort are illegal flows. In the context of this report these are flows where tax liabilities are evaded. Tax evasion is the illegal non payment or under-payment of taxes, usually resulting from the making of a false declaration or no declaration at all of taxes due to a relevant tax authority or a false claim for expenses for offset against income legally declared to a tax authority which might in either case result in legal penalties (that may be civil or criminal) if the perpetrator of the tax evasion is caught. This is the relatively easy part of illicit flows to define, and therefore to substantiate. It so happens it is also the larger part.

The second component of illicit flows are those that are legal but improper or irregular because they are not sanctioned by rules or customs but nonetheless are legal. In this context this relates to those flows where tax liabilities are avoided. Defining tax avoidance is harder than defining tax evasion precisely because there is no legal basis to rely upon when doing so. In this context tax avoidance is defined as seeking to minimise a tax bill without deliberate deception (which would be tax evasion) but contrary to the spirit of the law. It therefore involves the exploitation of loopholes and gaps in tax and other legislation in ways not anticipated by the law. Those loopholes may be in domestic tax law alone, but they may also be between domestic tax law and company law or between domestic tax law and accounting regulations, for example. The process can also seek to exploit gaps that exist between domestic tax law and the law of other countries when undertaking international transactions.

The result is that, as British judge Lord Templeman said[i]:

> *A tax avoidance scheme includes one or more interlinked steps which have no commercial purpose except for the avoidance of tax otherwise payable, and can conveniently be described as artificial steps. A tax avoidance scheme does not leave the taxpayer any better or worse off but leaves the Revenue worse off.*

As Lord Templeman noted in the same article, another British judge (Lord Brightman) said a tax avoidance scheme has the following characteristics:

> *First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e.) business end … Secondly there must be steps inserted which*

have no commercial (business) purpose apart from the avoidance of a liability to tax – not 'no business effect'.

The difficulty of defining tax avoidance does as a result become apparent. What also becomes clear is that the tax avoider faces uncertainty when pursuing their activities. That uncertainty focuses mainly on their not really knowing the true meaning of the laws they seek to exploit and taking the chance that either a) they may not be discovered to be tax avoiding or b) that if they are the interpretation placed on the law that they seek to exploit is favourable to them. Their risk of penalties arising as a result of their actions depends upon what the outcome of these risky situations might be.

Together those actions giving rise to illicit flows that may be defined as those acts, whether deliberate or negligent, that results in tax not being paid either:

a) contrary to the law, rules or customs of a jurisdiction on an economic event whose substance either occurs within that jurisdiction or that should have been recorded there, or
b) contrary to the laws of another jurisdiction in which a benefit of that economic event arises.

The essence of this is vital to what follows. What it in effect means is that an illicit flow occurs when:

1) An economic event occurs. This could be a sale, purchase, wage payment, gift, gain, payment of a return on investment, and much more besides.
2) That economic event is not taxed properly where it actually occurs. So, for example, if it occurs in Italy and is not taxed contrary to the law of Italy then tax has been evaded in Italy. If, alternatively, the economic event is reported in Italy but falls through loopholes in Italian law or is legal but nonetheless contravenes Italian rules or customs then tax avoidance has taken place in Italy.
3) That economic event should be recorded in a place other than that in which it really occurs and it should be also taxed in that other place, but is not so taxed. So, for example, if the transaction in the previous paragraph took place in Italy but should have been recorded by a company in Sweden but was not recorded in Sweden despite that fact then tax evasion would have taken place in Sweden.

An example might explain this. The economic event under consideration might be that a sale of software into Italy which should be subject to Italian VAT. If that VAT is not recorded in Italy there is tax evasion in Italy.

If on the other hand the sale was characterised as a transaction that should not have VAT applied to it in Italy by artificially changing the nature of the deal then it might be the subject of tax avoidance in Italy if that recharacterisation was successful in permitting the transaction to fall through a loophole even though doing so was contrary to the spirit of Italian tax law.

If the Swedish company that made the sale in Italy did not record the sale in Italy in its books in Sweden then it would also have evaded tax in Sweden on its income even if it had properly paid VAT in Italy.

And if the cash from the sale in Italy was sent straight to the shareholder of the Swedish company who did not then declare that cash receipt for tax purposes, having by-passed the company's books altogether, then evasion by the shareholder would also have taken place.

As is clear, international tax avoidance and evasion can very quickly take on a wide variety of forms. Tackling such issues within and between states is what tackling illicit financial flows is all about.

What should be clear is that:

1) Tax evasion and tax avoidance can happen on the same transaction for different taxes in different places;
2) Tax evasion and tax avoidance often involve elaborate trails involving more than one person, whether that person is a real live human being or a legal person such as a company, partnership, trust, foundation or charity;
3) This issue is complex but invariably involves following a trail of money to work out who really benefits from it, and where;
4) Moving transactions across international boundaries increases the opacity of transactions and so increases the chance that taxes can be evaded and avoided.

That inevitably means that tackling this issue is complex, expensive and potentially time consuming. That also means that effective deterrence can potentially provide very effective yields in terms of tax recovered, especially if the measures in question are effective in producing 'smoking guns' that suggest tax evasion is taking place with a significant chance of that evasion being discovered so encouraging taxpayers to be voluntarily tax compliant. That logic is implicit in much of this report.

To determine whether the investment of resources in such processes is worthwhile does, however, suggest that estimating the scale of the issue is vital and it is to this issue that attention is turned in the next part of this report.

Part 2: Estimating the Scale of the Problem

Any strategy for managing illicit financial flows requires the estimation of the extent of tax evasion and tax avoidance in Europe. Each issue is dealt with in turn here, starting with tax evasion.

Estimating the EU tax evasion gap

The process of estimating the EU tax evasion gap is, essentially, a three-part process:

1. First, the size of the shadow economy in Europe has been estimated. The shadow economy is the unrecorded economy in which illicit financial flows occur.

2. Second, the effective tax rates due in the EU member states are compared to data on the size of shadow economies.

3. Thirdly, the implied taxation loss by member state from tax evasion throughout the EU is estimated.

For verification purposes various benchmarking data is then used to ensure that the resulting estimates are reasonable[ii]. US data has also been used for reference on occasion due to its apparent quality[iii].

GDP data for this research came from the European Union[iv]. This data was compared to that from the World Bank[v]. GDP data should include the value of a state's shadow economy as defined for the purposes of this report. The two sources were very similar, although not identical. Since this is an EU study EU data was preferred.

Population data, when used, for the research came from official sources checked through Wikipedia as it appears to have most comprehensively assembled recent set of official estimates[vi].

Data on the size of shadow economies came from a World Bank working paper[vii] by Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro, published in July 2010. That paper specifically looked at the size of shadow economies, which they defined as including:

> *all market-based legal production of goods and services that are deliberately concealed from public authorities for any of the following reasons:*
> *(1) to avoid payment of income, value added or other taxes,*
> *(2) to avoid payment of social security contributions,*
> *(3) to avoid having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc., and*
> *(4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.*

As such they specifically sought to exclude criminal activities such as burglary, robbery, drug dealing, smuggling, etc., from their estimates, which makes their data appropriate for the purposes of this research.

Data on the overall tax rates in operation came from the European Union 2011 edition of 'Taxation trends in the European Union', Annex A, table 1. This data tended to be lower than that reported by the Heritage Foundation[viii] and for reasons of prudence, and because this is a European Union report has been preferred as a result.

Data on the overall tax rate and government spending as a proportion of GDP, used for some comparison purposes, came from the Heritage Foundation[ix].

Data on spending on healthcare as a proportion of GDP, again used for some comparison purposes, came from the World Health Organisation report 'World Health Statistics 2011', page 127 and following, all of which data has been checked by the WHO with national governments[x].

Exchange rate data for translation to local currencies when appropriate came from US Treasury data[xi].

Having assembled these various sources of data, the GDP of a state was multiplied by the size of the shadow economy in percentage terms to estimate the value of that state's shadow economy. This sum was then multiplied by the percentage overall tax burden of the state in question to estimate the total tax evaded in the state.

It is stressed that much of the data used to prepare these calculations, whether it be GDP , population data and overall tax rates, is estimated: that is the nature of macroeconomic information. The resulting research findings are also, therefore, by definition estimates. However, it is suggested that they are likely to be the best possible estimates and as such provide valuable insights into the scale of tax evasion and its likely impact on a country-by-country basis throughout the European Union.

The results of these calculations are as follows:

Country	GDP 2009	Size of Shadow Economy	Tax burden - 2009	Size of Shadow Economy	Tax lost as a result of Shadow Economy
	Euro'm	%	%	Euro'm	Euro'm
Austria	284,000	9.7	42.7	27,548	11,763
Belgium	353,000	21.9	43.5	77,307	33,629
Bulgaria	36,000	35.3	28.9	12,708	3,673
Cyprus	17,000	28.0	35.1	4,760	1,671

Czech Republic	145,000	18.4	34.5	26,680	9,205
Denmark	234,000	17.7	48.1	41,418	19,922
Estonia	15,000	31.2	35.9	4,680	1,680
Finland	180,000	17.7	43.1	31,860	13,732
France	1,933,000	15.0	41.6	289,950	120,619
Germany	2,499,000	16.0	39.7	399,840	158,736
Greece	230,000	27.5	30.3	63,250	19,165
Hungary	98,000	24.4	39.5	23,912	9,445
Ireland	156,000	15.8	28.2	24,648	6,951
Italy	1,549,000	27.0	43.1	418,230	180,257
Latvia	18,000	29.2	26.6	5,256	1,398
Lithuania	27,000	32.0	29.3	8,640	2,532
Luxembourg	42,000	9.7	37.1	4,074	1,511
Malta	6,200	27.2	34.2	1,686	577
Netherlands	591,000	13.2	38.2	78,012	29,801
Poland	354,000	27.2	31.8	96,288	30,620
Portugal	173,000	23.0	31.0	39,790	12,335
Romania	122,000	32.6	27.0	39,772	10,738
Slovakia	66,000	18.1	28.8	11,946	3,440
Slovenia	36,000	26.2	37.6	9,432	3,546
Spain	1,063,000	22.5	30.4	239,175	72,709
Sweden	347,000	18.8	46.9	65,236	30,596
United Kingdom	1,697,000	12.5	34.9	212,125	74,032
Total or unweighted average	12,271,200	22.1	35.9	2,258,223	864,282

On an unweighted average basis European shadow economies are 22.1% of total economic activity. When weighted this reduces to 18.4%. The implication is clear: larger economies in the EU tend to have smaller proportionate shadow economies. It is, nonetheless, the case that €1 in every €5.43 would appear to be in the shadow, unrecorded economy in Europe.

The resulting loss of tax when calculated on this basis is substantial. €864 billion of revenues are lost each year when estimated on this basis. It should be noted that if the tax burden as calculated by the Heritage Foundation was used and if World Bank GDP data (which tends to be a little higher than that produced by the EU) was used instead the resulting loss would be €927 billion a year.

To give some idea of the importance of this data the following table has been prepared:

Country	GDP 2009	Gov't spending as proportion of GDP	Health care spending as proportion of GDP	Size of Shadow Economy	Tax lost as a result of Shadow	Tax lost as a proportion of tax	Tax lost as a proportion of government spending	Tax lost on shadow economy as % of

					Economy	income		healthcare spending
	Euro'm	%	%	Euro'm	Euro'm	%	%	%
Austria	284,000	49.0	11.0	27,548	11,763	9.7	8.5	37.7
Belgium	353,000	50.0	11.8	77,307	33,629	21.9	19.1	80.7
Bulgaria	36,000	37.3	7.4	12,708	3,673	35.3	27.4	137.9
Cyprus	17,000	42.6	6.0	4,760	1,671	28.0	23.1	163.8
Czech Republic	145,000	42.9	7.6	26,680	9,205	18.4	14.8	83.5
Denmark	234,000	51.8	7.0	41,418	19,922	17.7	16.4	121.6
Estonia	15,000	39.9	4.3	4,680	1,680	31.2	28.1	260.5
Finland	180,000	49.5	11.7	31,860	13,732	17.7	15.4	65.2
France	1,933,000	52.8	3.5	289,950	120,619	15.0	11.8	178.3
Germany	2,499,000	43.7	8.1	399,840	158,736	16.0	14.5	78.4
Greece	230,000	46.8	7.4	63,250	19,165	27.5	17.8	112.6
Hungary	98,000	49.2	8.2	23,912	9,445	24.4	19.6	117.5
Ireland	156,000	42.0	7.6	24,648	6,951	15.8	10.6	58.6
Italy	1,549,000	48.8	5.1	418,230	180,257	27.0	23.8	228.2
Latvia	18,000	38.5	8.1	5,256	1,398	29.2	20.2	95.9
Lithuania	27,000	37.4	7.8	8,640	2,532	32.0	25.1	120.2
Luxembourg	42,000	37.2	4.1	4,074	1,511	9.7	9.7	87.8
Malta	6,200	44.8	16.5	1,686	577	27.2	20.8	56.4
Netherlands	591,000	45.9	10.8	78,012	29,801	13.2	11.0	46.7
Poland	354,000	43.3	7.1	96,288	30,620	27.2	20.0	121.8
Portugal	173,000	46.1	11.3	39,790	12,335	23.0	15.5	63.1
Romania	122,000	37.6	5.4	39,772	10,738	32.6	23.4	163.0
Slovakia	66,000	34.8	8.5	11,946	3,440	18.1	15.0	61.3
Slovenia	36,000	44.3	9.1	9,432	3,546	26.2	22.2	108.3
Spain	1,063,000	41.1	9.7	239,175	72,709	22.5	16.6	70.5
Sweden	347,000	52.5	9.9	65,236	30,596	18.8	16.8	89.1
United Kingdom	1,697,000	47.3	9.3	212,125	74,032	12.5	9.2	46.9
Total or unweighted average	12,271,200			2,258,223	864,282	22.1	17.6	105.8

This illuminates the significance of tax evasion in the European Union.

The shadow economies of the European Union are worth more than the total cost of health care in Europe. To put this another way, on average the tax lost as a result of the existence of shadow economies in Europe represents 105.8% of the total health care spending in EU countries.

Considered as an item of cost the tax lost as a result of the existence of shadow economies represents an unweighted average cost of 17.6% of total government spending in EU member states. This makes this tax lost one of the biggest single effective expenditure items for most governments in Europe. In a significant number of countries tax lost as a result of the shadow economy might represent more than 20% of total government spending and as a proportion of government revenues that sum lost does in some cases exceed 30% of total income. In only two cases – Luxembourg and Austria – is the tax lost as a result of the shadow economy less than 10% of revenues and even in countries such as Germany almost one euro in six of total revenues might be lost to tax evasion.

To again put this in context the following table compares these tax losses with government deficits and total government borrowing based on European Union data[xii]:

Country	GDP 2009	Size of Shadow Economy	Tax lost as a result of Shadow Economy	Annual deficit 2010	Tax lost as a % of annual deficit	Gov't borrowing 2010	Years it would take tax lost to repay debt
	Euro'm	Euro'm	Euro'm	Euro'm	%	Euro'm	
Austria	284,000	27,548	11,763	13,169	89.3%	205,212	17.4
Belgium	353,000	77,307	33,629	14,355	234.3%	341,019	10.1
Bulgaria	36,000	12,708	3,673	2,269	161.9%	11,428	3.1
Cyprus	17,000	4,760	1,671	926	180.4%	10,619	6.4
Czech Republic	145,000	26,680	9,205	6,815	135.1%	55,825	6.1
Denmark	234,000	41,418	19,922	6,318	315.3%	102,024	5.1
Estonia	15,000	4,680	1,680	-18	0.0%	951	0.6
Finland	180,000	31,860	13,732	4,427	310.2%	87,216	6.4
France	1,933,000	289,950	120,619	136,525	88.3%	1,591,169	13.2
Germany	2,499,000	399,840	158,736	81,630	194.5%	2,079,629	13.1
Greece	230,000	63,250	19,165	24,193	79.2%	328,588	17.1
Hungary	98,000	23,912	9,445	4,116	229.5%	78,596	8.3
Ireland	156,000	24,648	6,951	49,903	13.9%	148,074	21.3
Italy	1,549,000	418,230	180,257	71,211	253.1%	1,843,015	10.2
Latvia	18,000	5,256	1,398	1,386	100.9%	6,876	4.9
Lithuania	27,000	8,640	2,532	1,917	132.1%	10,314	4.1
Luxembourg	42,000	4,074	1,511	710	212.9%	7,661	5.1
Malta	6,200	1,686	577	226	255.2%	4,248	7.4
Netherlands	591,000	78,012	29,801	31,979	93.2%	371,028	12.5
Poland	354,000	96,288	30,620	27,966	109.5%	194,700	6.4
Portugal	173,000	39,790	12,335	15,783	78.2%	160,470	13.0
Romania	122,000	39,772	10,738	7,808	137.5%	37,576	3.5
Slovakia	66,000	11,946	3,440	5,207	66.1%	26,998	7.8

Slovenia	36,000	9,432	3,546	2,027	175.0%	13,704	3.9
Spain	1,063,000	239,175	72,709	98,227	74.0%	638,767	8.8
Sweden	347,000	65,236	30,596	0	0.0%	138,106	4.5
United Kingdom	1,697,000	212,125	74,032	176,488	41.9%	1,357,600	18.3
Total or unweighted average	12,271,200	2,258,223	864,282	785,563	139.3%	9,851,413	8.8

In every case where the tax lost as a consequence of the existence of the shadow economy as a proportion of the annual deficit exceeds 100% tackling tax evasion could, in theory, entirely clear the annual deficit in the country in question. This is true for 16 of the EU's member states, and is overall true for the EU as a whole.

In addition, if only part of the tax lost as a result of the existence of the shadow economy were to be collected then the problem of clearing the debts owed by EU governments would be much easier to tackle. The pressure to clear down debt across the EU would not disappear if the issue of tax evasion could be addressed, but the resources available to clear that debt would be substantially increased if that tax evasion was proactively tackled and debt would cease to be an issue threatening the well being of hundreds of millions of people in Europe as a result.

Words of caution

There are a number of notes of caution that are necessary at this juncture.

The first is that all these numbers are, of course, estimates. Some commentators will not agree with the way they have been calculated. Others will challenge these findings. So, for example, the UK's tax authority estimates that the UK tax gap from tax avoidance and tax evasion combined is just £35 billion[xiii] (€42.1 billion) and the above data indicates a figure much higher than this. However, there are many strong technical reasons to think that the UK seriously underestimates its tax gap[xiv]. In addition, other recent estimates of tax gaps might even suggest the estimates made above to be conservative: for example, an estimate of tax lost in the USA using the method adopted here, World Bank GDP data and Heritage Foundation tax burden estimates would suggest a tax gap as a result of the operation of the shadow economy in that country of US$337 billion. The US Internal Revenue Service[xv] did however in January 2012 issue its most recent estimate of that same tax gap and suggested it might be US$385 billion in 2006 after allowing for the recovery of US$65 billion of tax as a result of IRS investigations and late payments of tax. In other words, the methodology used here produced a result lower than that the IRS produced, suggesting the estimates made here may be conservative. The significance of this is that it is important to remember at all times that the figures calculated are estimates. That said, they also appear to fall into the range of plausible estimates, and that is, of course, important.

Secondly, it is important to note that whatever the estimate of tax lost might be there is no guarantee that all of that tax lost can be recovered. Indeed, it would be wholly unrealistic to think

that possible. There has always been tax evasion and no doubt there always will be. Any reasonable policy reaction to this data on the tax gap in the European Union must focus on reducing the tax gap, and not eliminating it.

Finally, it should be noted that some argue that reducing the tax gap during a period of austerity is an in appropriate course of action. Their argument is that all taxation reduces consumer demand in the economy and to therefore collect more tax at this time would reduce demand even more than is already happening and so increase the risk of recession in Europe. This argument is partial, and false. Whilst it is true that reducing tax rates (in the process increasing a fiscal deficit) is a mechanism for stimulating an economy during a recession because such behaviour should increase effective consumer demand this is a policy that only works when a government deficit results and if it is pursued within the legitimate economy, undertaken with a democratic mandate with the intention of delivering prosperity. Ignoring tax evasion is something very different indeed: that is turning a blind eye to criminality. That criminality does not increase demand, it reallocates the ability to consume from those who should enjoy it according to the democratic mandate (i.e. the government and those they wish to enjoy the benefit of their programmes of spending) to those who are willing to participate in criminal activity. If the government were to spend all the tax it could collect from tax evaders that government spending would stimulate demand just as much as the private consumption of tax evaders does: reallocating that consumption from those with legitimate right to undertake it to those without any such right does not change demand, it just changes those benefitting from the resulting consumption to ensure that those with legal and ethical right to that spending enjoy it and those who currently spend it as the proceeds of crime do not. To argue against tackling tax evasion on supposed economic grounds ignores this fact and ignores the importance of maintaining trust and the rule of law if an effective market economy is to be maintained.

This issue is addressed further below when considering why it is important that policy programmes be put in place to address these issues.

Comparison with EU estimates

It may be appropriate to compare these findings with a rare EU study of the tax gap, undertake in 2009 and looking solely at the VAT gap in 2006, most of which would have been attributable to tax evasion[xvi]. This suggested the gap in question was made up as follows:

Member State	Theoretical VAT liability	VAT receipts	VAT gap	VAT gap as a share of theoretical liability
AT	22,844	19,735	3,108	14%
BE	25,360	22,569	2,791	11%
CZ	9,216	7,541	1,675	18%
DE	164,115	147,150	16,965	10%
DK	23,611	22,560	1,051	4%
EE	1,325	1,215	111	8%
ES	63,013	61,595	1,418	2%
FI	15,176	14,418	758	5%
FR	140,817	131,017	9,800	7%
GR	21,746	15,183	6,563	30%
HU	8,882	6,813	2,070	23%
IE	14,043	13,802	241	2%
IT	119,197	92,860	26,337	22%
LT	2,335	1,826	510	22%
LU	1,961	1,941	20	1%
LV	1,751	1,374	378	22%
MT	463	410	53	11%
NL	41,269	39,888	1,381	3%
PL	23,784	22,127	1,657	7%
PT	14,371	13,757	614	4%
SE	29,294	28,487	807	3%
SI	2,764	2,647	116	4%
SK	4,632	3,320	1,312	28%
UK	155,697	128,721	26,976	17%
EU-25	907,667	800,955	106,712	12%

These findings are curious and run counter to expectations on the shadow economy. For example, it seems unlikely there would be just a 2% VAT gap in Spain but one as high as 22% in Italy: greater consistency would be expected between these two economies and other problems would very easily be highlighted. The data is not considered further for that reason.

ii. Estimating the EU tax avoidance gap

Estimating total tax evasion is, if not a straightforward task, one that is nonetheless much easier than estimating the amount of tax avoidance in an economy. There are very good reasons for this.

The first and the most obvious is that there is no strict legal definition of what tax avoidance is and therefore any estimate will always be subject to dispute by those who simply disagree on definitional issues as to what is and what is not tax avoidance.

Secondly, a great deal of tax avoidance activity involves cross border transactions. It is, therefore, notoriously difficult to determine where it might take place, even if it is known that it is occurring.

Thirdly, even official estimates – such as that by the IRS published in January 2012, tend to ignore the issue. The word 'avoidance' is not mentioned in their report[xvii]. The Swedish National Tax Agency is one that has not ducked this issue, but it is all too aware of the problems of preparing any estimate, saying in its 2008 report 'The Tax Gap Map for Sweden'[xviii]:

> *The uncertainty is considered greatest with regard to the tax gap with international connections and the tax gap for large companies, where there is a not insignificant amount of tax avoidance. In addition to the difficulty of calculating the size of the gap that exists it is in many respects difficult to decide what is a tax gap. The aim of the companies' measures is often to put themselves in a grey area where there is no clear answer to whether it is right or wrong. Depending on the assumptions made in the calculations the result may vary by several billion kronor.*

This leaves a very limited number of reports to look at that make any suggestion of the scope of tax avoidance in the EU and in each case the only real insight they offer is to indicate the scale of tax avoidance in proportion to tax evasion.

The Swedish report noted does just this. It notes that in Sweden in 2008 the international tax gap was made up as follows:

Type of tax	**Tax gap SEK bn**	**Proportion %**
Income tax, earnings	2.5	5
Tax on capital	8.3	18
Income tax, business activity	19.4	41
Social security charges	2.0	4
VAT	11.8	25
Excise duty	2.8	6
Other (rounding)	0	1
Total	46.8	100

It is very notable that the problems relate to business income, VAT (which is of course also related to business income: if the sales that should have been subject to VAT are suppressed so too in turn are the wages paid as a result and the profits arising) and to the hiding of wealth from tax authorities.

The best indication of how much of this relates to tax avoidance comes from the analysis of the various components that make up these figures. At most SEK 11 billion is described as avoidance, and then by large companies. That would be about 23.5% of the total international avoidance. Within data for the Swedish national economy there is little suggestion of tax avoidance in the observed tax gaps: of the SEK 66 billion domestic tax gap it was suggested that SEK 43 billion was the

suppression of income by micro companies, which is undoubtedly tax evasion whilst SEK 21 billion of 'other' tax gaps seemed mainly to relate to errors in tax returns and in the preparation of accounts which were not necessarily considered to be deliberate suppression of income, but were, for example, the result of over-claiming reliefs and allowances. Some of such claims may of course be tax avoidance that does not work, but it is not clear that is the case.

The Swedish survey therefore only categorically identified tax avoidance as being an activity undertaken by large companies as a result of their international transactions. Specific reference is made in the report to this relating to transfer pricing and the use of tax havens. Over the whole range of reported tax gaps this tax avoidance represents just 8.2% of the total SEK 133 billion gap, but a much smaller part of course of the total tax take of about SEK 1,300 billion, in relation to which it is less than 1%.

This needs to be compared with the United Kingdom, where more work has been done on this issue in a number of reports. In a pioneering work that motivated all the subsequent research on the UK tax gap, Richard Murphy (author of this report) prepared a report on tax avoidance for the UK's Trades Union Congress in 2008, entitled The Missing Billions[xix]. In that work he only addressed the issue of tax avoidance; tax evasion was not addressed by him for another two years. He estimated corporate tax avoidance was some £12 billion a year in 2006 and that individuals avoided £13 billion a year at that time. The total tax yield on the taxes considered in 2006 was approximately £330 bn[xx]. The overall rate of avoidance would, therefore, have been about 7.6% of taxes due.

The estimate has been controversial. The method used for calculating the corporate tax gap was to compare tax actually paid (excluding deferred tax) by the largest 50 companies in the UK with the headline tax rate when applied to profits and to extrapolate the resulting difference firstly to likely UK based activity of the companies surveyed and secondly to the largest 700 companies in the UK. By excluding deferred tax it was noted that any scheme deferring tax paid was treated as tax avoidance, a proposition considered acceptable in the sample surveyed because in the population surveyed over a seven year period there was on average a 0.5% decline in the effective current tax rate each year and no net reversal of tax deferrals from use of legitimate tax reliefs although such a trend would logically be expected unless such schemes were being used to continually defer liability as part of an organised policy to achieve that aim. The merit of the methodology was it sought to measure the gap across international boundaries, which has always provide to be hard to do, and did so by starting with accounting data.

This methodology was challenged by international accounting firm Deloitte as part of the UK government commissioned Foot report in 2009[xxi]. Their work, which was supposed to support a review of the use of the British Crown Dependencies and Overseas Territories for tax avoidance, was instead used to directly answer the points made by Murphy in his report for the TUC. It adopted the methodology Murphy used but then said that all the differences arising between expected and actual tax rates were the result of government intention in designing tax policy for business to exploit unless it could be shown that such use had not worked or had been subject to doubt in its

application. It therefore made the assumption that not only was all tax avoidance legal, as Murphy did, but that it was intended, which he did not. The Deloitte chosen measure of doubt in the application of tax policy was to measure the 'prior year adjustments' included in the accounts of many major corporations to show the difference between the estimated liabilities of one year and subsequent sums settled; this being in Deloitte's opinion a major of the items for which prudent reserve for payment had been included in the accounts but for which subsequent approval (or not) of the avoidance action had subsequently been given by a tax authority. The result was a very much lower estimate of UK corporate tax avoidance at just £2 billion, one sixth of the sum Murphy estimated. This is however the direct consequence of the assumptions made and not as a result of disputing Murphy's figures. It is curious to note that the report has hardly, however, ever been mentioned since publication, including by HM Revenue & Customs. The reasons for that can only be speculated upon. What is clear is that the basis for estimation used by Deloitte seems to lack any logic when it widely known that major corporations do undertake extensive tax planning with the intent of reducing their tax liabilities suggesting that such a low estimate is unlikely to reflect the reality of what is actually happening in practice.

The alternative measure for the UK is data published by HM Revenue & Customs itself, again from 2009 onwards and in direct response to Murphy's work. The latest version of this estimate, published in September 2012 is as follows[xxii]:

Table 1.1: Tax Gaps for HMRC administered taxes – 2008-09 and 2009-10 (£ billion)

Tax	Component	Point estimates (£ billion) [1,2,4]		Percentage tax gap [3]	
		2008-09	2009-10	2008-09	2009-10
Indirect taxes[5]					
Value Added Tax (VAT)		14.6	11.4	15.5%	13.8%
Spirits duty		0.1	0.1	2%	3.4%
Beer duty		0.4	0.6	10%	14%
Cigarette duty		1.4	1.1	13%	10%
Hand rolling tobacco duty		0.6	0.6	50%	46%
Great Britain diesel duty		0.7	0.5	5%	4%
Great Britain petrol duty[6]		0.0	0.0	0%	0%
Northern Ireland diesel duty[7]		0.1	0.1	27%	12%
Northern Ireland petrol duty[6,7]		0.0	-	16%	-
Other indirect taxes[8]		1.0	0.8	7%	6.0%
Total indirect taxes		18.9	15.1	12.7%	10.9%
Direct taxes					
Income Tax, National Insurance Contributions, Capital Gains Tax	Inaccurate self assessment returns from individuals (excluding large partnerships[9])	5.6	5.8		
	Business taxpayers	*5.0*	*5.1*		
	Non-business taxpayers	*0.6*	*0.8*		
	Inaccurate self assessment returns from large partnerships[9]	0.8	0.9		
	Inaccurate returns from small and medium-sized employers (PAYE)[10]	0.6	0.9		
	Inaccurate returns from large employers (PAYE)	2.0	2.0		
	Avoidance	1.4	1.5		
	Non-declaration of income and capital gains by individuals who do not receive returns	0.3	0.3		
	Ghosts[11]	1.3	1.3		
	Moonlighters[12]	1.8	1.8		
	Total	13.9	14.5	5.2%	5.8%
Corporation Tax	Businesses managed by the Large Business Service	1.3	1.2		
	Avoidance	*1.1*	*1.0*		
	Technical issues	*0.2*	*0.2*		
	Large and complex businesses	0.9	0.9		
	Small and medium-sized businesses	2.7	2.7		
	Total	5.0	4.8	10.3%	11.7%
Other direct taxes	Inheritance Tax	0.1	0.05		
	Stamp Duties[13]	0.8	0.5		
	Stamp Duty Land Tax	*N/A*	*0.2*		
	Shares Stamp Duty	*N/A*	*0.3*		
	Petroleum Revenue Tax	0.05	0.02		
	Total	0.9	0.6	6.5%	4.9%
Total direct taxes		19.8	19.8	6.0%	6.5%
Total tax gap		39	35	8.1%	7.9%

It is important to note that:

1. The estimate for 2008-09 was restated downwards in this report from that published in September 2010, when the total tax gap was stated to be £42 billion[xxiii].
2. The total tax gap for 2007-08, the first year for which data was published, was estimated to be £40 billion[xxiv].
3. The figure for 2009-10 was lower than previous estimates not because of an increase in the effectiveness of H M Revenue & Customs in recovering tax due but because the standard rate of VAT in the UK fell for most of that year from 17.5% to 15%, so reducing the estimated VAT gap. Since that VAT rate has now risen from 15% to 20% it is highly likely that the VAT gap has also risen substantially since 2009-10 and, as a result, the overall tax gap is likely to be significantly higher when next reported.
4. The reasons why the H M Revenue & Customs estimates are considered likely to seriously underestimate the tax gap with regard to direct taxes (but not VAT) take more explanation than there is room available for here, but for those interested are explained in documents linked in a footnote[xxv]. The simplest explanation is that the VAT tax gap rate, running at an average of around 13% for a period of around a decade after missing trader fraud has been taken out of consideration (this being the only statistic that the UK has a longer track record of publishing) is the only figure in the entire set of H M Revenue & Customs published tax gap data calculated on a reliable macro-economic basis that is consistent in approach with the data noted on tax evasion prepared for the purposes of this report. All data relating to direct taxes such as income tax is extrapolated from returns actually received by H M Revenue & Customs or investigations they undertake. The problem with this approach is that it ignores that tax due by those who entirely escape the tax system due to their tax evasion and that is exactly what the data is meant to record, but does not as a result.

These points being noted, the H M Revenue & Customs estimate for tax avoidance as opposed to tax evasion and mistakes is very low and appears to amount to just £2.5 billion a year. For the reasons noted in The Missing Billions[xxvi] this is very unlikely to be true. It is also unlikely to be untrue as, again as the UK TUC has noted[xxvii], the UK government announced measures closing down more than £1 billion of tax loopholes in a period of little over a year in 2008-09. It seems incredibly unlikely they identified and closed 50% of all UK tax evasion in that period. The H M Revenue & Customs lacks plausibility as a consequence.

In that case it can safely be concluded that the figure far tax avoidance is somewhat higher than the estimate made by the governments of the UK and Sweden for their respective economies but that extrapolation from the data prepared by Murphy for the UK TUC may be unwise, not least because of the unusual concentration of large multinational corporations registered in the UK to make use of its financial markets. If government estimates set a floor for estimates of less than 10% of the amount tax evaded and Murphy sets a ceiling at maybe 35% of tax evaded a sum in between is still significant: simply averaging the two might suggest total EU tax avoidance amounting to a sum as

high as €150 billion per annum. That is, of course, a much lower figure than that for tax evasion, although in combination such an estimate would also, it should be noted, make the European Union tax gap in excess of €1 trillion a year.

The conclusion of such a review is, however, obvious: it is clear that tackling this issue has to be the highest priority for governments seeking to recover their missing billions of lost tax revenues, and it is to this issue that attention is turned next.

Part 3: Tackling the Problem

Having estimated the scale of the problem within the European Union caused by tax evasion and tax avoidance it is clear that this issue needs to be addressed. If total losses from tax evasion might exceed €850 billion a year and losses to tax avoidance may amount to €150 billion a year then a total loss of €1 trillion of potential tax revenues a year is clearly an issue of great significance worthy of considerable attention at a time when tax revenue is one of the scarcest and most valuable commodities in the whole of the European Union.

To understand what might be done to tackle the issues of tax avoidance and tax evasion the mechanisms used to undertake such activities need to be understood first of all.

The structures used for the purposes of tax avoidance are different from those used for tax evasion. This is because tax avoidance is, by definition, done through legal mechanisms where full disclosure of transactions takes place but where the outcome is not which was intended by a parliament or a tax authority. Tax evasion, on the other hand, involves at least some illegal misrepresentation of a transaction. This may be the complete non-disclosure of the transaction contrary to the requirements of the law, or might be the non-disclosure of some part of the information needed to properly appraise the transaction.

Each is considered in turn here, starting with tax avoidance.

Tax avoidance

When a person pays the tax a government expects of them they are said to be tax compliant. Tax compliance is defined as seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

By definition, therefore, a person who is tax avoiding does one or more of these things:

1. They pay less than the right amount of tax;
2. They may pay tax in the wrong place;
3. They may pay tax at the wrong time;
4. They declare their tax liabilities in such a way that the substance of the transactions undertaken does not accord with the form in which they are declared for tax purposes.

In general this means that a tax avoider seeks to do the following:

1. Reallocate their income to a person or entity that has a lower tax rate than the person whose activity really generates the income. The people or entities to whom the income is diverted might be:

    a. Other members of a person's family e.g. a spouse or children;
    b. A company, possibly registered in a different location to create a lower tax rate or with a different ownership, commercial or management structure intended to achieve the same goal;
    c. A trust or foundation for the benefit of a person's family;
    d. In the case of those who can legally make use of them (as tax avoidance is being considered here), an offshore company or trust.

2. Changing the location of a transaction. This is much easier if companies, foundations or trusts are used than for an individual, who is usually resident in a single place and often finds it quite hard to move. It is easier still for a parent company of a group of companies that can simply create new subsidiaries in alternative countries to change the location in which a transaction is recorded.

3. Changing the nature of a transaction so that it appears to be something different from what it actually is. This is commonplace, the most popular tactics being to:

    a. Convert income into capital gains, which are almost always taxed at lower rates;
    b. Convert earned income into unearned income such as dividends to avoid social security charges or payroll taxes that only apply to earned income;
    c. Provide benefits in kind to an employee that are taxed at less than their full value.

4. Delay recognition of income e.g. delaying a bonus so that it is taxed later, so saving on cash flow in the meantime. Companies may achieve the same goal by investing successfully in assets that attract tax relief before the cost associated with them is recognised for accounting purposes, so manipulating their earnings to inflate the value of quotes companies, in particular.

5. Obscuring the information available on a transaction, at which point tax avoidance begins to blur into tax evasion.

It is important to note that none of these actions describe a situation where a person simply claims the allowances and reliefs that are allowed to them in the tax law of the place in which they live. So, for example, tax avoidance does not include:

1. Claiming the tax allowances that reflect the personal circumstances of a person and which are made available in law;

2. Claiming allowances for expenses properly incurred and which may be offset against income before tax is calculated, whether that is income from employment, self-employment or from investments. Such expenses may include contributions to pension funds, the cost of union subscriptions in some countries and travel or training costs related to an employment where these may be reclaimed for tax purposes;

3. Claiming genuinely incurred business expenses that may be offset against income before tax is calculated on the resulting net profit;

4. Investing in ways that attract low tax rates because the law has stated that allowance to be desirable.

It immediately becomes apparent that enormous problems arise in tackling tax avoidance because in so very many cases it is hard to work out whether the lower tax rate a person enjoys is the result of tax avoidance or as a result of the intention of the parliament of the country in which the tax is due. Obvious areas of concern include the following types of tax avoidance, with the policy incentive that creates opportunities for abuse being highlighted:

Type of tax avoidance	Policy incentive that encourages avoidance	Mechanism used to avoid tax	Policy change required to address issue and problems arising from them
1. Income earning asset transferred to a spouse or child to	Treating the family as separate individuals for tax purposes when	Payment of investment income, in particular, to members of the	Treat families as integrated economic units.

reduce tax rate on future income stream	they clearly have economic interests in common.	household who do not really own the capital giving rise to it or the payment of wages that have not really been earned to a member of a family by a person who is self employed or running a family company to reduce overall tax rates.	Problems: 1. Favours people living together and discourages marriage; 2. Discourages genuine family businesses which are important in many economies; 3. Might increase tax rate of families with non-working parents prejudicing well-being of children.
2. Income earning asset or business transferred to a company that pays lower tax than the individual who runs it would pay if the income was received in their own name.	Low corporate tax rates, supposedly to encourage business.	Incorporation of the business. In some countries that also provides opportunity for the resulting income to then be: 1. Spread with other family members; 2. Transform earned income into unearned investment income (dividends) that then avoid payroll and social security taxes and may be taxed at lower rates; 3. Transform earned income into capital gains, possibly on	Align the tax rates of small, family owned companies with that of the owners. Treat small limited liability entities as tax transparent and tax their owners on the income they generate, whether or not it is paid to them in similar fashion to the tax treatment of partnerships. Align income tax and capital gains tax rates. Charge investment income derived from privately owned limited companies to the equivalent of the

		artificial liquidation of the corporate entity.	payroll and social security tax charges that might have been paid on it if paid as a salary.
3. Income generating asset transferred to a trust or foundation.	Lower tax rates paid by trusts or foundations either on income, capital gains or wealth taxes or the advantage of sheltering that income from being taxed on any one person until such time it is decided who shall have benefit of it.	The use of a foundation or trust as allowed either under the law of the country in which the taxpayer transferring the asset is resident or under the law of another jurisdiction where such arrangements are legally permitted and to which they are allowed legal access.	Treating the income or gains of a trust as that of the settlor, donor or founder of the arrangement until such time as beneficiaries are appointed to receive that income or until such time as income is apportioned to other parties. As such the arrangement becomes tax transparent.
4. Transferring the ownership of an income generating asset or trade to a company in a jurisdiction different to that in which the owner of the entity, whether a living or legal person, resides to take advantage of the lower tax rates enjoyed by that legal entity registered in another country.	Maintenance of tax rates for legal entities that are higher than those in other jurisdictions. Allowing access to the use of limited liability entities to persons, whether living or legal, in another jurisdiction (the 'freedom to incorporate' and the right to the 'free flow of capital' rules of the European Union).	Use of tax haven companies. Use of transfer pricing to relocate profits to low tax jurisdictions. Relocation of mobile capital assets to low tax jurisdictions. Use of the right to make payment from trading companies in one country to asset owning companies in another country without the withholding of tax on interest, royalties, copyright fees, licenses, rents and	Restrict the free flow of capital. Remove the right to incorporation at will. Require the withholding of tax on payments of interest, royalties, copyrights, license fees, rents and similar charges. Enhance controlled foreign company regulation. Extend the definition of tax residence to include many tax haven entities.

		other such charges. Re-registration of the ownership of assets, such as land, in one jurisdiction into the legal ownership of a legal entity such as a company in another jurisdiction to relocate the legal location of ownership of that land with the object of changing the wealth and property related taxes due as a result, or to avoid capital taxes.	Better regulate transfer pricing. Introduce a common consolidated corporate tax base based on unitary apportionment formula principles. Look through the ownership of land and other usually immobile assets (including trades and businesses) recorded as owned in limited liability entitles in jurisdictions different to that in which they are actually located and tax them on the basis of their actual location. Tax capital gains on the basis of where the asset sold is located, not where its legal ownership is recorded. Revise the concept of residence for both companies and their groups so that both the company and its share register are deemed to be located in the place where the central day-to-day management of the company is located, which will by default be where its

			commercial head office is located unless strong evidence to the contrary can be proven. In the process the location in which the entity is legally incorporated will be ignored if not the same as the location of its commercial head office. Attempts to relocate companies and the groups they own by simply changing the location in which board meetings are held to be ignored for corporate taxation purposes.
5. Change the nature of a transaction so that it is declared in a form different to that which has really arisen.	The offering of significantly different tax rates for income and capital gains; earned and unearned income; remuneration paid as salary and as benefits in kind (such as the provision of cars and other assets for the employees use that do not have an alternative cash value in their hands but from which they secure benefit nonetheless); different treatments of income for tax and social security purposes; rate	Investment in assets that roll up income so that a gain is crystalized on sale rather than income during the period of ownership. Representing some types of business income e.g. hedge fund carried interests as being capital gains arising rather than income earned. Incorporating businesses and paying dividends out of profits rather than salaries out	Aligning capital gains and income tax rates. Charging the equivalent of social security charges on investment income above relatively modest annual limits. Simplifying tax systems to reduce the number of allowances and reliefs available to be abused. Making specific disallowance of allowances and reliefs for those most likely to

	differentials for VAT purposes in some states; reduced rates of wealth tax for assets invested in some types of property e.g. private companies in some states.	of income so that lower tax rates on investment income are paid and social security charges are avoided. Creation of complex salary arrangements to exploit loopholes in tax arrangements for share payments, benefits in kind and other such arrangements. Manipulating the nature or place of supply for VAT purposes to secure lower VAT rates. Reorganising asset portfolios with the intention of avoiding wealth taxes.	have the resources to avoid tax, most of whom will be in higher income brackets. Simplifying wealth taxes. Ceasing to use the tax system to provide investment and other incentives within the economy and encouraging governments to directly intervene in the economy instead in pursuit of their economic objectives.
6. Delay recognition of income	Any incentive that gives a deduction during a present period that can reverse in a future period is available for this purpose. Pension fund contributions clearly meet these criteria but are encouraged by policy and are not usually considered to be tax avoidance. The availability of	Using pension funds and associated tax reliefs fro those without relevant earnings. Provision of excessive investment incentives whether for capital or property or through the creation of enterprise zones and other such arrangements induce tax driven investment to shelter income from current taxation.	Simplification of the tax system. Ceasing to offer incentives for investment through the tax system and offering direct government grants instead if intervention is considered desirable. Greater intervention in accounting standard setting processes to ensure accounts form

	pension funds for tax planning by those who do not have income e.g. children is however a different matter. Accounting arrangements that allow income to be deferred between periods when the substance is that the income has been earned encourage such deferral: this is likely if different accounting bases are used by different companies within one group of companies. Offering investment incentives that do not match the underlying risks and rewards e.g. offering tax deduction in full for investment costs incurred in the year when investment occurs even though the benefits may last for a number of years provides incentive for avoidance. Differing treatment of income and expenses for tax and accounting purposes has the same effect.	Creating complex group structures within and between countries using different accounting systems allow income to be deferred both within and most especially across international borders as differing accounting rules on the recognition and timing of income are exploited. This has become more commonplace due to the differences in income recognition in some International Financial Reporting Standard and local Generally Accepted Accounting Principles. Exploitation of tax rules that do not reflect accounting principles. Creation of arrangements that tip income from one year into the next.	a suitable basis for the assessment of corporation taxes. Requiring the disclosure of the consequence of differing accounting systems on the calculation of group taxation liabilities. Introducing a requirement that the accounting for taxation within company accounts be disclosed to tax authorities as part of the tax return disclosure requirement so that the calculation of deferred taxation provisions in those accounts, the transactions that gave rise to them and the anticipated timing of reversal can all be made plain for tax authorities to appraise and question if appropriate. Aligning the taxation of transactions as far as possible with their accounting and economic substance. Introduction of a general anti-avoidance principle with regard

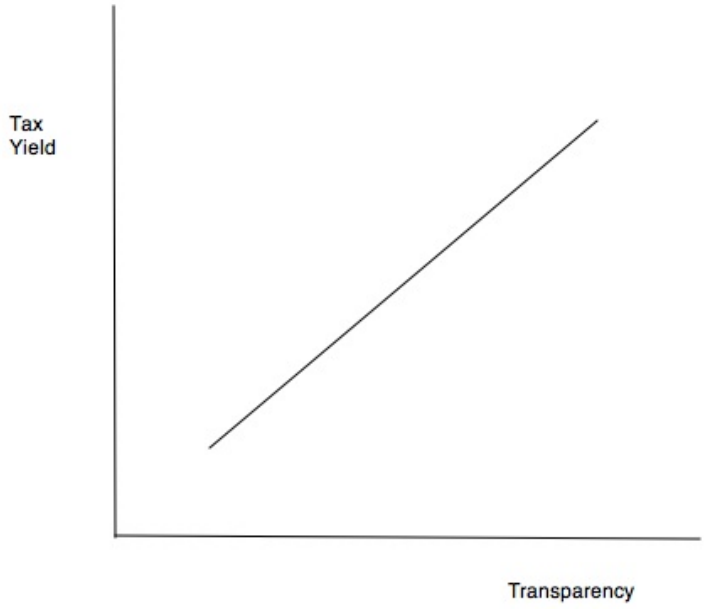
	Delayed payment of some income e.g. from employment, or from investments or on the realisation of gains can defer tax payment for a year in many cases.		to taxation. Introduction of tax planning disclosure schemes such as the DOTAS (Disclosure of Tax Avoidance Schemes) requirement in the UK[xxviii]. Introduction of Codes of Conduct for tax practitioners and taxpayers requiring disclosure of tax avoidance arrangements giving rise to tax deferral as part of any tax return to which they relate.
7. Obscuring the information available on a transaction to assist the goal of avoiding tax.	Failure of governments to ensure proper international cooperation between tax authorities. Failure to tackle tax haven secrecy. Failure to require proper accounting standards suitable for use as the basis for corporation tax. Failure to require adequate disclosure of accounts by small and medium sized enterprises.	The use of artificial structures that have an element of secrecy attached to them that obscure the true nature of the transaction undertaken. These might be trusts. They may well be offshore. They could be companies that exploit loopholes to file limited information on their activities. The structure may use	Substantially enhanced international cooperation and information sharing on tax matters including adoption of the revised European Union Savings Tax Directive. Creation of registers of trusts. Enforcement of regulation on maintaining registers of companies. Requiring enhanced accounting by all companies for their tax affairs.

	Tolerance of banking secrecy. Failure to register and regulate trusts. Failure to require the proper disclosure of beneficial ownership of companies and trust. Willingness to accept that the legal form of transactions has precedence over their commercial substance.	nominees to disguise true ownership without the law ever being broken. There may be shifting of income to others e.g. family members undertaken offshore that is hidden from view because of limited or non-existent information sharing arrangements with other countries. There might simply be tax returns that are complete but do not 'lay all their cards face up on the table' about the tax planning that achieved the declared result. There could be accounting within and between group companies that need not be disclosed because intra-group transactions can be hidden from view under too many existing accounting rules so that transfer pricing and other arrangements are not apparent to users of accounts and tax authorities.	Requiring the disclosure of tax accounting to tax authorities as part of corporation tax returns. Requiring the disclosure of tax avoidance arrangements if their treatment as tax evasion is to be avoided. The matters referred to in section 6, above. Compulsory disclosure of all intra-group accounting in all company accounts. A requirement that a person resident in a state disclose all the companies and trusts with which they or their family or group of companies are connected as part of their tax return and the placement of the accounts of all such entities on record with their tax authority.

As is apparent tax avoidance is both complex and gives rise to numerous difficulties for those wishing to tackle it.

In particular it is obvious that tax avoidance does on many occasions exploit principles that are fundamental to the economic logic on which the European Union has been founded. Many of the issues noted, especially in categories one to five, are difficult to tackle whilst the concept of economic freedom is maintained within the European Union on the basis of its philosophy that the free movement of capital always increases well being even though it is very obvious in these cases that this may not be true, at least as far as the governments of Europe are concerned.

It is also very obvious that there are direct conflicts between tax yield and transparency in very many of the matters noted. Indeed, it is not unreasonable to suggest that the relationship shown in the following graph holds true:



As transparency increase so does taxation yield. Unsurprisingly, transparency is, therefore a focus of the measures for tackling tax avoidance, especially in the context of the issues noted in the later sections, and most especially section 7, above.

Before addressing those issues though it is important to note that whilst business will say that increased transparency imposes cost on them that is not true for the economy as a whole. It is opacity that imposes cost on the economy as a whole, and not just because of the cost of tax avoidance. As the most basic understanding of classical and neoclassical economics makes clear, opacity results in sub-optimal decision making in market economies. It is only when there is the best possible information available to all participants in markets that optimal decisions can be made on:

1. Where to invest the resources of a company for best return;
2. What prices to charge;
3. When to exit a market;
4. Which portfolio of assets to hold within financial markets;
5. Where it is best to locate.

Transparency therefore increases the prospects of the highest overall real returns in both the real economy where goods and services are made and sold and in financial markets that meet the needs of commercial companies and individuals for capital. Opacity reduces the efficiency of those markets just as it reduces the tax yield of governments. That opacity does, however, increase post tax returns of some market participants who choose to abuse the asymmetry that it creates to avoid their tax obligations. Those processes that increase tax yield should therefore increase the efficiency of markets in the European Union as well: it is unfortunate that this is rarely appreciated.

That said there are issues noted above that would be very effective in tackling tax avoidance but which it is unlikely can be addressed in the short term. The following fall into this category and are noted here for the sake of completeness before moving on to consider those other issues more likely to be effective in the short term in tackling tax avoidance:

1. Treat families as integrated economic units.

2. Align the tax rates of small, family owned companies with that of their owners.

3. Treat small limited liability entities as tax transparent and tax their owners on the income they generate, whether or not it is paid to them in similar fashion to the tax treatment of partnerships.

4. Align income tax and capital gains tax rates.

5. Charge investment income derived from privately owned limited companies to the equivalent of the payroll and social security tax charges that might have been paid on it if paid as a salary.

6. Treating the income or gains of a trust as that of the settlor, donor or founder of the arrangement until such time as beneficiaries are appointed to receive that income or until such time as income is apportioned to other parties. As such the arrangement becomes tax transparent.

7. Restricting the free flow of capital so that can be more effectively traced for tax purposes.

8. Removing the right to incorporation at will.

9. Require the withholding of tax on payments of interest, royalties, copyrights, license fees, rents and similar charges.

10. Enhancing controlled foreign company regulation.

This still leaves the following issues that could be considered for action:

1. Better regulate transfer pricing.

2. Introduce a common consolidated corporate tax base based on unitary apportionment formula principles.

3. Look through the ownership of land and other usually immobile assets (including trades and businesses) recorded as owned in limited liability entitles in jurisdictions different to that in which they are actually located to ensure that they are properly taxed on the basis of their actual location.

4. Tax capital gains on the basis of where the asset sold is located, not where its legal ownership is recorded.

5. Revise the concept of residence for both companies and their groups so that both the company and its share register are deemed to be located in the place where the central day-to-day management of the company is located, which will by default be where its commercial head office is located unless strong evidence to the contrary can be proven. In the process the location in which the entity is legally incorporated will be ignored if not the same as the location of its commercial head office. Attempts to relocate companies and the groups they own by simply changing the location in which board meetings are held to be ignored for corporate taxation purposes.

6. Simplifying tax systems to reduce the number of allowances and reliefs available to be abused.

7. Making specific disallowance of allowances and reliefs for those most likely to have the resources to avoid tax, most of whom will be in higher income brackets.

8. Cease to use the tax system to provide investment and other incentives within the economy and encouraging governments to directly intervene in the economy instead in pursuit of their economic objectives.

9. Cease to offer incentives for investment through the tax system and offering direct government grants instead if intervention is considered desirable.

10. Make greater intervention in the accounting standard setting processes to ensure accounts form a suitable basis for the assessment of corporation taxes.

11. Require the disclosure of the consequence of differing accounting systems on the calculation of group taxation liabilities.

12. Introducing a requirement that the accounting for taxation within company accounts be disclosed to tax authorities as part of the tax return disclosure requirement so that the calculation of deferred taxation provisions in those accounts, the transactions that gave rise to them and the anticipated timing of reversal can all be made plain for tax authorities to appraise and question if appropriate.

13. Align the taxation of transactions as far as possible with their accounting and economic substance.

14. Introduction of a general anti-avoidance principle with regard to taxation.

15. Introduce tax planning disclosure schemes such as the DOTAS (Disclosure of Tax Avoidance Schemes) requirement in the UK[xxix].

16. Introduce Codes of Conduct for tax practitioners and taxpayers requiring disclosure of tax avoidance arrangements giving rise to tax deferral as part of any tax return to which they relate.

17. Substantially enhanced international cooperation and information sharing on tax matters including adoption of the revised European Union Savings Tax Directive.

18. Create registers of trusts.

19. Enforce regulation on maintaining registers of companies.

20. Compulsory disclosure of all intra-group accounting in all company accounts.

This list is clearly very extensive, and all are feasible but priorities for action have to be established. Those issues that are most likely to provide yields in this area, both in cash terms and politically in terms of publicity will result from addressing tax avoidance by companies and in particular multinational corporations, whether publicly or privately owned. The regulation of their advisers is also likely to be of considerable benefit. The recommendations to be made will therefore concentrate on these issues but before making such suggestions some particular issues that will become the focus of attention need to be explained in more depth. These issues are:

1. Transfer pricing;

2. Group accounting, and most especially its interaction with transfer pricing and tax havens;
3. Corporation tax accounting;
4. The obligations of auditors and other professional advisers.

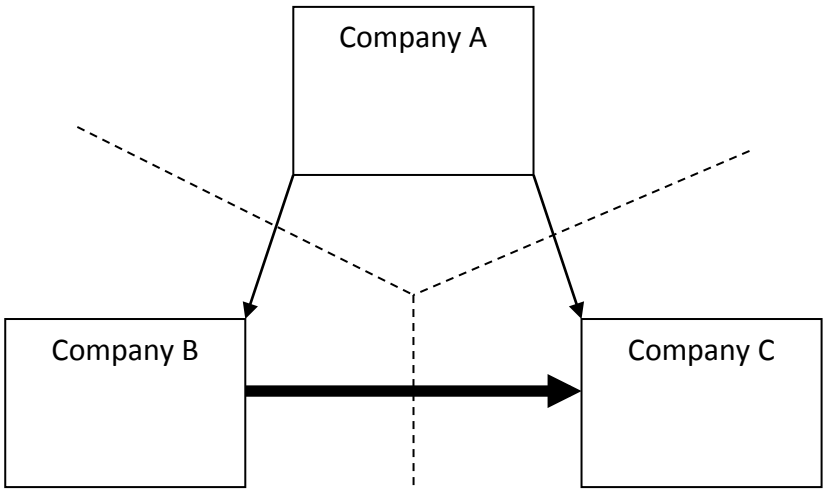
Each is considered in turn before recommendations on tackling tax avoidance are made.

Transfer pricing

It is important to note for the discussion that follows that transfer pricing takes place whenever two legal entities are under common control and trade with each other.

Common control of the companies that are trading might mean that one company that is trading owns the other, or it might mean that both are owned by another party who could be an individual, a trust, or another company. The nature of the control does not matter: what matters is that it exists and that the entities then trade with each other. Nor in theory does it matter whether the companies involved are in separate countries: transfer pricing takes place within states as well as between them but for a number of reasons, mostly related to the taxation treatment of groups within most EU countries, is rarely of such taxation significance in that case.

For ease of explanation the following diagram might help:



Company A owns Company B and Company C (the narrow arrows). Each of the companies is in a separate country, indicated by the dashed line (although as noted above, transfer pricing also applies within a country, it just tends not to be a matter of concern when that is the case). Company

B and Company C trade with each other (the broad arrow) and even though neither owns the other they do transfer price when doing so because they are both owned by Company A.

It is said that Company B and Company C transfer price because they could in theory sell goods and services between them at any price they choose because it would have no impact upon the reported results of the group of companies owned by the shareholders of Company A if the price they used were not the same as the market price. In saying this it is important to note that a group of companies only makes a profit under consolidated accounting rules when it actually deals with an independent third party customer. As a result transfer pricing does not change the total sum of pre-tax profit a group can make: it does instead change where it makes it and therefore what tax is due upon it. Transfer pricing therefore changes post-tax and not pre-tax profits.

Setting prices at will as Companies B and C might do may well produce a result for the shareholders of Company A that they think in their best interests but doing so may produce an outcome that is unacceptable for the taxation authorities of the countries in which Company B and Company C are located. If Company B is in a country with a low tax rate but Company C is in a country with a higher tax rate, then there is a very strong incentive for Company A to ensure that Company B overprices the goods or services that it supplies to Company C. This would have the result of over-stating the profit in Company B but of understating the profit in Company C. The result would, of course, be that Company B overpaid tax compared to that which should be due but that this overpayment would have arisen at a low tax rate whereas Company C would under-declare its profits and have less profit chargeable to tax at a higher rate as a result.

To use an example, if £1 million of profit was shifted from Company C to Company B as a result of mispricing and the difference between the tax rate of the two countries was 20% then an overall saving of £200,000 would have resulted from this artificial setting of prices compared to the tax that would have been due if a market price had been used for the transactions between companies B and C. Transfer pricing rules for tax purposes try to prevent this abuse.

These rules, as promoted by the Organisation for Economic Cooperation and Development (OECD), require that market prices should be used on all intra-group trades undertaken on an international basis. However, this is an incredibly difficult rule to enforce for a great many reasons – not least due to the difficulty of proving what market prices might be when in a great many cases there is no open market for the goods and services supplied within a group and there is no comparable market from which data to establish such prices can be drawn. It is only when full information on the trading of a group as a whole is available that it can really be seen whether proper transfer pricing rules are in operation or not. If they are not then transfer mispricing is said to be taking place.

Group accounting, transfer prices and tax havens

The difficulty of identifying when transfer mispricing might be taking place is also compounded by a number of other factors. The first is the sheer difficulty of identifying that companies are under common control when the secrecy in tax havens is used and abused by multinational corporations.

There are regulations that require companies throughout Europe to disclose all the companies they own or are associated with and in which jurisdictions those subsidiaries and associates are registered. However, as research by the Tax Justice Network[xxx] and Action Aid in the UK has shown, that data is poorly maintained and updated even by the largest companies and many company registries seem unaware of the obligation to demand it. As such knowing which companies make up a group of companies can be very hard to establish in a great many cases, and since the disclosure on company registries need not be audited there is no way of verifying if the data disclosed is true or not.

The second problem is that because the accounts of companies located in tax haven and some other jurisdictions are never put on public record identifying the profit that multinational corporations make in tax havens is very hard to do, and quite often impossible in very many cases. Many multinational corporations seek to exploit this situation to their advantage. One way in which they do so is by refusing to supply the accounts of their tax haven subsidiaries to countries making enquiry of them for transfer pricing purposes. This makes the case of a country that thinks it is losing tax to a tax haven subsidiary of a multinational corporation very difficult to prove because they then have no data on the other side of transactions multinational company subsidiaries enter into in their jurisdictions. That data is very important in such cases if it is to be proven that profit has been misallocated as a result of the transactions being challenged.

The third problem is inherent in the nature of the accounts produced by major corporations. The single set of bound glossy accounts sent to shareholders by such companies actually represents just one possible view of the transactions undertaken by a group of companies. That view includes all the third party transactions of the group of companies to whom the accounts relate i.e. their trading with people who are unrelated to it. It is argued that this view provides the information that the shareholders in the top company of a group (Company A in the example) want – which is how 'their' directors have managed 'their' money for them. But that one and only view of the group as a whole also eliminates from view some incredibly important information, including details of all intra-group trading i.e. that which takes place between the companies under common control. It is, of course, in these transactions, that are hidden from view in these accounts, that transfer mispricing will arise. When this suppression of intra-group trading is mixed with the non-availability of information on the trading activity of many multinational corporation group companies in tax havens and other locations, as that information is not required on public record in those places, there is a perfect scenario created that ensures that some of the most important information for tax purposes required by tax authorities is simply not available to the user of accounts, including many tax authorities. If this was a mistake it would be a problem. Unfortunately it is deliberate; the International Accounting Standards Board has made it very clear that it does not see that it has any duty to assist the provision of information on transfer pricing by making it explicitly clear that the

accounts it produces should not be considered suitable for assessing intra-group trading and transfer pricing. As it says in introductory note number 7 to International Accounting Standard 24:

> *Discussions [in the standard] on the pricing of transactions and related disclosures between related parties have been removed because the Standard does not apply to the measurement of related party transactions.*

That is an extraordinary statement to make. What it means is that accounts prepared under International Financial Reporting Standards and their US equivalents are the basis of corporate taxation in a great many countries in the world but the International Accounting Standard, who is responsible for their promulgation, says that it is not their purpose to assist measurement of transfer pricing related matters. But if not, then where is that issue to be dealt with, one wonders? Clearly the European Union and its member states have to take greater control of this issue, and demand that the International Accounting Standards Board, who they have given the right to issue accounting standards for Europe that have the effective power of law, should ensure that the accounts prepared using those standards are fit for the purpose of ensuring that the right amount of tax is paid in the right place at the right time. If they are not fit for that purpose then it falls on the European Union to consider imposing its own requirements for disclosure, and that possibility is addressed below.

Lastly when considering this particular issue, there is always the possibility of subterfuge, although this is more likely in privately owned companies. In such companies it is relatively easy for the private owners to establish an offshore company, the ownership of which they then disguise using nominees and trusts. Goods or services are then sold to this entity by one company under common ownership and are repurchased from it by another entity also under common ownership but because that common ownership is not disclosed transfer pricing rules do not appear to apply and profit is then left offshore. This process, known as reinvoicing, is still thought commonplace but is very hard to detect. It is, of course, fraudulent but if, as is still true in many countries in the world, there are inadequate transfer pricing rules in place then that fraud is not a criminal offence and can therefore be considered closer to tax avoidance than tax evasion.

The impact of these issues is substantial: the OECD estimates that 60% (and maybe more) of world trade is undertaken on an intra-group basis[xxxi]. The result of the chosen basis of accounting for the world's largest multinational corporations is that none of this trade ever appears in the published accounts of multinational corporations. In fact, most is never seen in any accounts on public record anywhere because many of the companies through which trading takes place will be in tax havens and they do not require that the accounts notionally trading from those locations place accounts on public record. The current world regulatory environment for the accounting of multinational corporations therefore provides them with the perfect cover for the most commonplace tax avoidance activity that they undertake, which is transfer mispricing. Methods of tackling this issue are discussed below.

Corporation tax accounting

It is not only in the area of transfer mispricing that the accounting conventions of the European Union and elsewhere provide companies with considerable assistance in hiding just what they are doing. Rules on the basis on which companies pay tax and the way in which they have to disclosure their tax accounting also provide them with considerable assistance in hiding their tax affairs from view.

Multinational corporations and other large corporations rarely consist of just one company. They are group entities frequently made up of hundreds of companies, most of which will be subsidiaries. These subsidiaries will be spread in many cases across many countries. Although it is the group of companies that the Board of Directors manage, and it is the group whose profits really matter to the shareholders companies are not taxed as group entities at present: they are taxed as if each and every member company was an entirely separate organisation, each agreeing its affairs in isolation but for rules on transfer pricing and some other less important issues. The result is that this situation can be exploited for the benefit of the group as a whole. The obvious ways are by:

1. Transfer mispricing, as noted above;
2. Shifting income generating assets into low tax territories;
3. Running treasury functions from tax havens;
4. Keeping profits offshore if that means they are not taxed at higher rate in the parent company location;
5. Seeking to 'double dip' – that is to get tow lots of tax relief on one transaction. Leasing is a mechanism used for this purpose on occasion;
6. Trading off accounting rules so that profit and losses are recognised in different places at different times to defer paying tax.

Other opportunities also exist. As noted, the current structure of accounting hides such arrangements. But so too does the fact because the group is not taxed as a whole tax authorities are not allowed to look at its accounting and yet a great deal of the tax planning of the group will be reflected in that accounting. The group has, of course, to reflect the overall group position. The fact that tax has therefore been deferred by using the above arrangements to preserve cash (which is a major motivation for this activity, plus the fact that many incentive schemes for directors appear to include incentive to reduce tax paid, rather than tax potentially due, so encouraging cash deferral) does not mean that the potential tax due one day on the deferral can be ignored in the group: that group has to decide when or if that tax might potentially be due and where and make provision for it if appropriate in what is called its deferred tax provision. The accounting for that provision will, therefore, disclose much of what the group is doing to defer tax, almost by definition.

However, because calculating a deferred tax provision does not impact the calculation of a group's pore tax profit on which tax is based there is no obligation on a company to disclose its deferred tax

accounting to a tax authority. But that has to be wrong: what is ion that accounting is critical to understanding its tax and its planning.

It is also true that because tax is not paid on group accounts that a tax authority cannot usually access data on how those group accounts are prepared either, but they of course show the entries that reconcile the profits deferred, the transfer mispricing and so much else. All the transactions that reallocate group profits for tax purposes are recorded in the consolidation entries used to prepare group accounts. Again, it seems vital that tax authorities have access to this data if they are to assess the tax risks in any multinational corporation.

As noted earlier in tis report, the goal of reform to tackle both tax avoidance and tax evasion at this time is to provide the 'smoking gun' information that would alert tax authorities to the cases they really need to investigate whilst at the same time putting taxpayers on notice that they are much more likely to be discovered undertaking abuse in future. Access to accounting information achieves this goal.

The obligations of auditors and other professional tax advisers

As noted above, group accounts prepared in accordance with International Financial Reporting Standard (and all in Europe will be) are not meant to disclose data highlighting tax risk. Indeed, the International Accounting Standards Board who are responsible for promulgating these standards do not even rank tax authorities amongst the user groups for whom they think accounting data should be prepared and do not suggest that the accounting standards they promote necessarily provide information suitable for taxation purposes.

This immediately suggests the conflict of interest for auditors: amongst the data they have to certify to be true and fair in a set of accounts are the tax provisions for taxes due, and deferred. However, those same accounts will assist the agreement of the tax liability owing and yet may not be fit for that purpose because they do not disclose all the necessary information required to ensure that a proper assessment of that liability can be made if a company chooses not to make further disclosures to their tax authority.

Auditors, and indeed tax advisers, are usually members of publicly regulated bodies established with the goal of promoting public benefit. However, over many years it has become clear that many audit firms and their associated tax advisory arms have been closely involved in promoting tax avoidance about which they are unlikely to be objective. For example, few if any auditors of multinational corporations will be objective about tax haven usage when almost all the Big 4 firms of accountants have offices in almost all the world's major tax havens[xxxii].

It is for this reason of the obvious conflicts of interest that are inherent in these processes that a code of conduct for auditors and other advisers engaged on tax issues is essential, with that code

being backed up by penalties for those who do not comply, which penalties should also impact their clients.

Tackling tax avoidance

Having noted these issues and the range of measures available to address tax avoidance priorities can be established.

As noted earlier in this report, the goal of reform to tackle both tax avoidance and tax evasion at this time is to provide the 'smoking gun' information that would alert tax authorities to the cases they really need to investigate whilst at the same time putting taxpayers on notice that they are much more likely to be discovered undertaking abuse in future. That is the focus of the recommendations made here to address corporate tax avoidance, which is likely to firstly yield greatest return on effort expended and second have greatest likelihood of changing the general attitude towards tax avoidance, which is vital at this time. This is not to ignore the other issues raised above: they are also important but have not been subject to detailed analysis here, not least because in some cases the action required is self evident whilst in others is too remote a possibility to justify consideration now.

The issues to be focussed upon are therefore as follows, with the issues they tackle being noted beside them:

Proposed reform	**Matters tackled**
Introduce country-by-country reporting	Transfer pricing, lack of transparency in group accounts, reallocation of profits to tax havens.
Introduce Common Consolidated Corporate Tax Base	Transfer pricing, reallocation of profits to tax havens.
Support general anti-avoidance principle	Sophisticated tax avoidance.
Introduce accounting reform	Requiring the disclosure of data needed to disclose transfer pricing issues, lack of disclosure in small company accounts, group trading.
Change corporate accounting disclosure for tax purposes	Lack of information available to tax authorities on the tax accounting of companies that lets them hide the impact of their tax avoidance from view.
Promote Codes of Conduct	The failure of professional advisers to multinational corporations and other taxpayers of the tax avoidance that they undertake.

Country-by-country reporting

Country-by-country reporting is an alternative, and additional, method for reporting the results of multinational corporations created by Richard Murphy in 2003[xxxiii].

Country by country reporting would require disclosure of the following information by each multinational corporation in its annual financial statements:

1. The name of each country in which it operates;
2. The names of all its companies trading in each country in which it operates;
3. What its financial performance is in every country in which it operates, without exception, including:
   - It sales, both third party and with other group companies;
   - Purchases, split between third parties and intra-group transactions;
   - Labour costs and employee numbers;
   - Financing costs split between those paid to third parties and to other group members;
   - Its pre-tax profit;
4. The tax charge included in its accounts for the country in question split as noted in more detail below;
5. Details of the cost and net book value of its physical fixed assets located in each country;
6. Details of its gross and net assets in total for each country in which operates.

Tax information would need to be analysed by country in more depth requiring disclosure of the following for each country in which the corporation operates:

1. The tax charge for the year split between current and deferred tax;
2. The actual tax payments made to the government of the country in the period;
3. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period;
4. Deferred taxation liabilities for the country at the start and close of each accounting period.

Sales information will also require additional analysis. Sales can be recorded on two bases. The first is from where they are recorded as having arisen, or their origin. The second is in the place where the customer is, or their destination. If these two figures were more than 10% different in any case then country-by-country reporting would require that data be declared on both bases so that there was clear understanding of both the source and destination of the sales a multinational group makes.

In addition, if the company operated within the extractive industries we would also expect to see a full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates broken down between these categories of reporting required in the Extractive Industries Transparency Initiative[xxxiv].

The proposal requires this information be disclosed for all jurisdictions in which a multinational corporation operates unless turnover or purchases, whether third party or intra-group were less than £6 million a year, in which case more limited information could be disclosed. Anything less than this disclosure will not do or transactions might be lost to view.

Importantly, this proposed accounting standard does not require each country to agree to this disclosure since it is suggested that the requirement should be imposed either by an International Financial Reporting Standard[xxxv] or by international agreement; for example by the requirements imposed across the European Union by the Accounting and Transparency Directives. A proposal to include a version of country-by-country reporting for the extractive industries only in both the Transparency and Accounting Directives is, of course, already in progress.

The benefits of country-by-country reporting are wide ranging, and little could do more to ensure that the necessary transparency that will by itself induce responsible taxation management should prevail. In detail those benefits are:

Data disclosed	**Information need met**
1. The name of each country or jurisdiction in which a multinational corporation operates;	• Discloses geographic spread of the multinational corporation • Advises host communities of the presence of the multinational corporation in their jurisdiction • Indicates presence in locations likely to be subject to geo-political risk • Indicates exposure to local regulatory and tax regimes.
2. The names of all its companies trading in each country or jurisdiction in which it operates;	• Identifies completely and accurately the full groups structure of a multinational corporation, a feat rarely possible at present • Lets a multinational corporation be properly identified in the host communities that facilitate its activities • Allows those engaging with a multinational corporation locally to identify ultimate responsibility for the entity with which they are trading • Ends the corporate culture of secrecy about activities in many jurisdictions, whether they are secrecy jurisdictions or not • Means a multinational corporation is accountable for all its actions – a pre-condition of corporate social responsibility.
3. Sales, both third party and with other group companies. Sales information will also require additional	• The extent and direction of sales flows by multinational corporations will be documented • The full extent of intra-group sales will be understood for the first time

analysis. If sales to any state are more than 10% different from the figure from any state then data should be declared on both bases so that there is clear understanding of both the source and destination of the sales a multinational group makes	• The use of tax havens / secrecy jurisdictions as locations for the routing of intra-group transactions will be properly understood • The splitting of sales from the location in which a service is received from the jurisdictions from which they are billed will be capable of identification, an issue of particular significance in services where limited data on sales flows is currently available • The relocation of sales for tax purposes will be identifiable • The risk inherent in internal supply chains will become apparent
4. Purchases, split between third parties and intra-group transactions	• This data is requested to complement that on sales: when the sales of a multinational corporation from a jurisdiction are largely matched by intra-group purchases it is likely the jurisdiction is being used for re-invoicing purposes and transfer mispricing may be taking place: a cause of concern to almost all tax authorities • The extent of outsourcing in source jurisdictions likely to be at the start of supply chains can be identified, especially when compared to labour data (see below) • The vulnerability of supply chains can be identified • By comparing intra-group purchases and intra-group sales likely intra-group supply chains can be established • Sourcing from locations with high geo-political risk should be identifiable
5. Labour costs and employee numbers	• The organisation of labour by jurisdiction within multinational corporations can be identified • Unusual incidence of value added in proportion to labour cost can be identified • The likelihood of outsourcing can be identified • Average reward per employee by jurisdiction can be calculated • Trends in labour relationships over time can be monitored
6. Financing costs split between those paid to third parties and to other group members	• Financial flows indicate where financial assets and liabilities are located within and beyond multinational corporations: disclosure of income and payments, especially on an intra-group basis will indicate the extent to which profits are relocated through the use of debt that creates internal and external financial risk within the multinational corporation
7. Pre-tax profit;	• Pre-tax profit is, without exception, the principle starting point for determining:

	○ The location of retained reserves ○ The ability to finance activity without recourse to third parties ○ The likelihood of ongoing financial stability of the entity ○ The potential for making payment of taxation liability on income arising • Pre-tax profits located in many countries where there is considerable corporate secrecy are currently wholly unascertainable • The presence of significant profit in locations where most purchases and / or sales are intra-group might indicate artificial relocation of profits • The absence of profits in locations where it would be expected there should be considerable value added e.g. in source locations for extractive industry supply chains, might indicate transfer pricing issues • Persistent losses in a jurisdiction might indicate the misallocation of resources by a multinational corporation, as might strongly differing profit rates between jurisdictions • Significant profits arising in politically sensitive jurisdictions might indicate vulnerable future earnings • Significant earnings in tax havens / secrecy jurisdictions might indicate high tax risk or unsustainably low tax charges indicating a likely change in future after tax earnings ratios • Significant profits arising outside a parent company location where corporate taxation is assessed on a remittance basis might indicate limited access to funds for dividend distribution purposes
8. The tax charge for the year split between current and deferred tax;	• The extent to which a tax charge is expected to arise when compared to headline tax rates indicates the effectiveness of a tax regime in capturing income for tax assessment purposes • The degree to which corporate tax liabilities can be deferred indicates the existence of incentive allowances out of alignment with economic costs incurred, and indicates future potential reversal and erratic cash flows • The ratio of tax paid to profitability across jurisdictions is at present unknown: country-by-country reporting would

	provide it and indicate the extent and nature of cross border tax planning and international tax arbitrage • If a declared tax rate appears aberrant it may indicate unsustainability
9. The actual tax payments made to the government of the country or jurisdiction in the period;	• It is not accruals made for tax that allow governments to meet their obligations – it is cash in its bank accounts that allows it to do that: cash paid is the ultimate proof of tax settled. This data is currently entirely unavailable and as such the contribution of multinational corporations to individual national economies is very hard to assess • It is cash that is the subject to corruption: it is cash for which governments have to be held to account. This data is vital for that purpose • Cash settlements of less than liabilities declared in earlier years suggest the presence of undetected tax planning or corruption. In either case the effectiveness of the tax regime of the jurisdiction is in question.
10. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period	• This data is required to undertake an overall tax reconciliation for a jurisdiction: tax due at the beginning of the period plus the current tax charge for the period less tax paid should equal the closing liability. If it does not there is indication of irregularity in accounting or in the statement of taxes due, in either case worthy of investigation • The failure of a jurisdiction to collect tax owing to it is indicated by this data: if tax outstanding relates to more than one year prime facie there is a tax collection problem within the jurisdiction or the entity is declaring liabilities in its accounts that are inconsistent with those declared to tax. In either case problems are indicated
11. Deferred taxation liabilities for the country or jurisdiction at the start and close of each accounting period.	• Deferred taxation indicates any of these things: ○ Excessive allowances offered by he jurisdiction ○ The existence of significant tax avoidance ○ A non-alignment of taxation with underlying economic reality • In each case there is cause for concern
12. Details of the cost and net book value of its physical fixed assets located in each country or jurisdiction and	• Without indication of the capital dedicated by a multinational corporation to a jurisdiction it is not possible to calculate: ○ Rate of return on capital employed in the jurisdiction and to compare these

13. Details of its gross and net assets in total for each country or jurisdiction in which operates.	○ To determine whether capital invested justifies the level of profit reported ○ To determine whether capital assets are being appropriately allocated to support labour productivity, or not ○ To determine where assets and liabilities are likely to be within a group and whether they are as a consequence available a) to shareholders and b) to creditors
14. A full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates broken down between the categories of reporting required in the Extractive Industries Transparency Initiative if the multinational corporation is engaged in extractive industry activities	• Required for all the reasons noted by the Extractive Industries Transparency Initiative

As noted: these benefits from the data noted are indicative and should not be considered complete.

In combination it is suggested that this data would contribute to the benefits users of the financial statements of multinational corporations would secure from the transparency created by country-by-country reporting.

In summary, country-by-country reporting would:

- Provide a stakeholder view of accounting;
- Create reporting of results by country, without exception, which has previously been unknown;
- Provide a new view of corporate structures;
- Impart a new understanding of what the business of a corporation is, and where it is;
- Opens up a new perspective on world trade because intra-group transactions would be reported for the first time in multinational company accounts;
- Give a new view of world labour markets;
- Create an entirely new tool for geo-political risk profiling of companies;

- Permit better appraisal of corporate contributions to the governments that host their activities and in the process contribute to constraining corruption on the part of some recipient governments;
- Provide better awareness of the true extent of tax haven activity;
- Allow measurement of tax lost through tax planning by corporations through the relocation of profit via transfer pricing;
- Provide a better understanding of the physical resource allocation of the corporate world.

The result is that the data provided by country-by-country reporting would have three obvious consequences:

1. It would provide the best ever risk assessment tool for tax authorities seeking to tackle transfer mispricing. Simply analysing the results of a multinational corporation stated on a country-by-country reporting basis would let a tax authority appraise the likelihood of if and where transfer mispricing was taking place and let them then open the necessary enquiries with the companies within the group located in their jurisdiction knowing that they were already in position of a great deal of the information they would need on the other side of the transactions into which those companies had entered. Transfer mispricing would be much harder to undertake in that case, with considerable taxation loss saved as a result.

2. Because many of the fanciful corporate arrangements used at present to avoid tax would be eliminated from group structures if country-by-country reporting were in operation, since it would reveal their use, simpler group structures should result, so increasing the chance of effective corporate governance being in place. In addition, since this would then mean that decisions on the allocation of resources within a group would be driven solely by where money might be made from their use and not by tax considerations the effectiveness of decision making would increase and the prospect of long term profits being earned would rise.

3. Civil society, including politicians, journalists and those interested in the companies in which they invest, would have a better idea of who did and did not pay the tax expected of them in the right place at the right time, and this is likely to have a significant impact on investment behaviour, its responsibility and the long term returns it generates.

The yields from country-by-country reporting are not just from taxation as a result.

Country-by-country reporting could be introduced in Europe. Indeed, the current proposals for country-by-country reporting in Europe for the extractive industries could be easily amended to achieve this goal in the very near future.

Common Consolidated Corporate Tax Base

As the EU itself says[xxxvi]:

> *The Common Consolidated Corporate Tax Base is a single set of rules that companies operating within the EU could use to calculate their taxable profits. In other words, a company or qualifying group of companies would have to comply with just one EU system for computing its taxable income, rather than different rules in each Member State in which they operate.*
>
> *In addition, under the CCCTB, groups using the CCCTB would be able to file a single consolidated tax return for the whole of their activity in the EU. The consolidated taxable profits of the group would be shared out to the individual companies by a simple formula so that each Member State can then tax the profits of the companies in its State at the tax rate that they - each Member State - chooses, (just like today.)*
>
> *The European Commission on 16 March 2011 proposed a common system for calculating the tax base of businesses operating in the EU.*
>
> *The proposed Common Consolidated Corporate Tax Base (CCCTB), would mean that companies would benefit from a "one-stop-shop" system for filing their tax returns and would be able to consolidate all the profits and losses they incur across the EU. Member States would maintain their full sovereign right to set their own corporate tax rate.*

As yet the Commission proposal has not got the backing of all member states. The proposed formula for allocating the profits between member states has also not been agreed, but the principles behind this proposal are important, and mesh incredibly well with country-by-country reporting and so require further explanation.

The proposal for a Common Consolidated Corporate Tax Base is, in effect, to introduce what is technically called unitary taxation. Unitary taxation overcomes the inherent conflict between the way in which groups of companies report their accounting data and the way in which they are taxed which have been noted above. Whilst accounting encourages a group view and ignores the individual companies that make up the entity, presently tax is only ever charged on the individual entities. This makes group accounts, in a sense, meaningless for tax purposes. This is why country-by-country reporting will always at present provide a better and more objective view of a group's tax liability than can ever be presented in the group consolidated accounts.

A further advantage of the same country-by-country data would be that it would also allow any user of the accounts to determine if the group's profits and tax liability appear to have been reasonably apportioned. This can be done by applying what are, in effect, unitary taxation apportionment formulas to the country-by-country data that a company would be required to publish if this system of accounting were to be adopted.

Under the rules of unitary taxation, which are widely used to allocate profits between companies operating in different states within the USA and have therefore been extensively tried and tested, the total group profit is allocated to the locations in which the multinational corporation trades on the basis of a formula. The classic apportionment formula used in unitary taxation is called the Massachusetts apportionment and it allocates profit on the basis of a formula that gives equal weighting to third-party sales, employees, and physical fixed assets in a location. With one minor amendment the EU is proposing to use this formula[xxxvii]. One of the reasons for requiring employee and fixed asset information to be disclosed under country by country reporting is to ensure that this calculation can be undertaken. The purpose of doing so is to ensure that the profit allocation between states looks reasonable.

An example helps at this point. Note the group of companies (Companies A, B and C) used to explain transfer pricing, above. Now suppose that company A, located in country A, which has a corporation tax rate of 30%, has two subsidiary companies. The first is company B, which is in a tax haven with a corporation tax rate of 0% and the second is company C, which is in a developing country with a tax rate of 35%.

Company A and Company C only make sales to genuine third-party customers. They do not trade directly with each other. Company B only makes sales to company A and company C; It makes sales to no third-party customers because its only activity is to own the intellectual property that is used exclusively by companies A and C. That intellectual property was created by company A and was transferred to company B some time ago. Company B has only to maintain a lawyer and a small team of administrators to generate the income that it earns. In contrast, companies A and C employ staff to undertake tasks in order to supply the services that their customers want.

The pattern of trading for a year looks like this:

Country by country reporting

		Company A $'m	Company B $'m	Company C $'m	Eliminated $'m	Consolidated Group $'m
Turnover	Third party	400	0	100		500
	Intragroup		80		-80	0
	Total	400	80	100		500
Purchases	Third party	150	0	30		180
	Intragroup	65	0	15	-80	0
	Total	215	0	45		180
Employees	Cost	135	1	42		178
	Number	3000	10	2800		5810
Profit before tax		50	79	13		142
Tax	Current	11	0	1		12
	Deferred	4	0	3	24	31
	Total	15	0	4		43
Profit after tax		35	79	9		99
Apparent tax rate		30%	0%	31%		30%
Fixed assets		200	5	150		355

Companies A, B and C are all in separate countries so each has to prepare individual and separate sets of accounts in order to record all the transactions that they undertake. These are shown in the separate columns under their company names, above. As is apparent, company A pays company B $65 million dollars a year for the use of its intellectual property and company C makes a payment of $15 million for the same entitlement. It is stressed that these figures are probably high; the exaggeration is, however, necessary to highlight what happens.

Company A also makes genuine third-party purchases and has a significant employment cost in respect of some 3,000 people. Company C employs 2,800 people, but it will be noted at a somewhat lower cost per head. This is normal for operations located in developing countries.

All of the companies make a profit before tax. In combination the group makes a healthy $142 million profit before tax on a turnover of $500 million.

Company B is the most profitable in the group but has no tax liability.

Company A enjoys what appears to be a reasonable profit rate and declares a total tax liability at 30%, which is the exact expected rate due in its country. Of this liability, however, $4 million is deferred tax: it will not be due until a subsequent period. This may be because of additional

allowances due to it in respect of expenditure on capital equipment in the period in excess of the equivalent depreciation charge included in the accounts as a measure of the wearing out of those assets in use during the period.

Company C also declares a tax liability, but at a rate slightly lower than the notional rate for the country in which operates. There is nothing very surprising about this. Recent research has shown that most quoted companies in the UK declared tax liabilities that are slightly below the notional corporation tax rate and that they actually pay tax, on average, at a rate at least 8% lower than that notional rate[xxxviii]. Of company C's tax liability, 75% is deferred. This is commonplace in developing countries where tax allowances on capital expenditure tend to be very generous.

It is important to note that in all likelihood the accounts of company B and the accounts of company C will not be available on any public record for inspection. So long as company A prepares group accounts on a consolidated basis, in most countries it will not have to make available the accounts of company B and company C. The group result will be sufficient to satisfy its disclosure requirement.

The group result arising from these individual company accounts is reflected in the right-hand column. It will be noted that the intra-group sales and purchases are eliminated when the consolidation is prepared. Group accounts only include transactions with third parties, and current assets and liabilities owed by and owing to third parties. As a result the only actual transactions undertaken by company B that are reflected in the group accounts are the payments to its staff amounting to less than $1 million. The curious will note that these employees are on average the best remunerated within the whole group.

In this first table it will be noted that although the intra-group transactions with company B are eliminated from view when the consolidation takes place, a provision for the tax that might be due on the profit transferred to the tax haven has been included in the consolidated accounts. This provision is $24 million, being tax at 30% on the $80 million profit earned in Company B. There are two reasons for making this provision. The first might be that the payments to company B might be challenged by the tax authorities in countries A or C, and a tax liability might arise as a result. It is assumed that the average rate of that liability would be 30%. Alternatively, it is assumed that the tax saving created by use of company B is only temporary and that if and when the profits of that company are transferred to company A for onward payment to its shareholders, a tax liability will arise in that country at 30%. This will require deferred tax to be provided now on the liability that is expected to arise in the future.

Neither assumption need be true, of course. If the tax saving that the operation of company B has created passes the scrutiny of the relevant tax inspectors in countries A and C, then there will be no need to provide deferred tax for fear of the arrangement being challenged: this will not happen. In addition, if the company is satisfied that it does not need to bring the reserves in company B back to country A for onward distribution to its shareholders, there is no reason for it to provide deferred tax on the potential cost of that distribution. Thirdly, and is becoming increasingly common

throughout the European Union, there may be no tax due on the remittance of funds from foreign subsidiaries if they are not considered controlled foreign companies. In that case a very different set of accounts is presented with as a result there being a very different tax charge:

Country by country reporting

		Company A $'m	Company B $'m	Company C $'m	Eliminated $'m	Consolidated Group $'m
Turnover	Third party	400	0	100		500
	Intragroup		80		-80	0
	Total	400	80	100		500
Purchases	Third party	150	0	30		180
	Intragroup	65	0	15	-80	0
	Total	215	0	45		180
Employees	Cost	135	1	42		178
	Number	3000	10	2800		5810
Profit before tax		50	79	13		142
Tax	Current	11	0	1		12
	Deferred	4	0	3		7
	Total	15	0	4		19
Profit after tax		35	79	9		123
Apparent tax rate		30%	0%	31%		13%
Fixed assets		200	5	150		355

The only difference between the two tables is in the taxation charged in the consolidated group result. In the second table the taxation liabilities of the individual companies are simply added together. The current tax liability of the group is now shown to be just 8.5%. When deferred taxation is taken into account the liability appears to rise to 13%. Of course, this is substantially lower than the potential tax rate due in country A - where company A is located.

Two tax arrangements made this second table more likely. The first is that a “dividend exemption arrangement” is in operation in country A. When a dividend exemption arrangement is in operation, income paid by way of dividend from a subsidiary company to a parent company is not subject to tax in the country in which the parent company is located upon its receipt. As a result – in this case if the $79 million of retained profits in company B was paid by way of dividend to company A and if a dividend exemption was in operation – no further tax would be due in country A. However, if there was no dividend exemption in operation, the dividend would be taxed at 30% upon receipt in country A and the deferred tax provision noted in the first example would be appropriate. It is very

obvious as a result why multinational corporations are in favour of the dividend exemption basis of taxation as recently introduced in the UK, for example.

The second reason why the profits of company B may not be taxed is that country A, in which company A is located, either does not have a foreign company taxation regime or has only a weakly controlled one. Controlled foreign company taxation regimes were created in the 1980s to tackle the issue that this example highlights, namely the transfer of profits, particularly from passive sources of income such as royalties and copyright fees paid to tax havens. They work by simply deeming the tax haven subsidiaries to be resident in the country where the parent company is; in this case country A. The income of the tax haven subsidiary is then taxed as if it arose in the parent company location, even though it technically did not. These arrangements were effective for a while, but have increasingly come under fire, particularly in the European Union. The arrangements now apply to much narrower ranges of income and only apply in particular circumstances, which most companies are able to avoid. When weakly controlled foreign company regimes are coupled with dividend exemption arrangements the opportunity for companies to locate profits in tax havens increases significantly.

What the example does make clear is that – although the company has gone to considerable efforts to secure a tax saving – there would be very few clues in the consolidated accounts published in the second version as to why the tax rate paid by company A was much lower than the expected tax rate of 30%. The reason for the benefit, which the company secured from its tax haven operation, would be almost entirely hidden from view.

This is because, using the second example as the basis for demonstration, under consolidated accounting the disclosure would be as follows:

Country by country reporting

		Consolidated Group $'m
Turnover		500
Purchases		180
Employees		178
Profit before tax		142
Tax	Current	12
	Deferred	7
	Total	19
Profit after tax		123

Whereas under country-by-country reporting this data would be published (excluding all balance sheet and cash flow related information, which would be additional to that information noted here):

Country by country reporting

		Country A $'m	Country B $'m	Country C $'m	Consolidated Group $'m
Turnover	Third party	400	0	100	500
	Intragroup		80		0
	Total	400	80	100	500
Purchases	Third party	150	0	30	180
	Intragroup	65	0	15	0
	Total	215	0	45	180
Employees	Cost	135	1	42	178
	Number	3000	10	2800	5810
Profit before tax		50	79	13	142
Tax	Current	11	0	1	12
	Deferred	4	0	3	7
	Total	15	0	4	19
Profit after tax		35	79	9	123

In this way, the quantity and quality of data that country-by-country reporting would disclose becomes readily apparent.

Now taking this example and the considering unitary taxation using two different bases for allocating employment, one being based upon employment cost and the other being based upon headcount, the relevant apportionment ratios are shown at the foot of the following table:

Country by country reporting

		Company A $'m	Company B $'m	Company C $'m	Eliminated $'m	Consolidated Group $'m
Turnover	Third party	400	0	100		500
	Intragroup		80		-80	0
	Total	400	80	100		500
Purchases	Third party	150	0	30		180
	Intragroup	65	0	15	-80	0
	Total	215	0	45		180
Employees	Cost	135	1	42		178
	Number	3000	10	2800		5810
Profit before tax		50	79	13		142
Tax	Current	11	0	1		12
	Deferred	4	0	3	24	31
	Total	15	0	4		43
Profit after tax		35	79	9		99
Apparent tax rate		30%	0%	31%		30%
Fixed assets		200	5	150		355
Third party sales weighting		80%	0%	20%		100%
Employee number weighting		52%	0%	48%		100%
Employee cost weighting		76%	1%	24%		100%
Fixed asset weighting		56%	1%	42%		100%

If these weightings are in turn weighted equally (as the Massachusetts formula does and as the proposed European Union formula also does), then the following calculations can be made:

Weighting for unitary allocation on a 33.3%: 33.3%: 33.3% basis:	Company A	Company B	Company C	Eliminated	Consolidated Group
Third party sales weighting	26.7%	0.0%	6.7%		33.3%
Employee number weighting	17.2%	0.1%	16.1%		33.3%
Employee cost weighting	25.3%	0.2%	7.9%		33.3%
Fixed asset weighting	18.8%	0.5%	14.1%		33.3%
Allocation if employee numbers count:	62.7%	0.5%	36.8%		100.0%
Allocation if employee cost counts:	70.7%	0.7%	28.6%		100.0%
Allocation if employee cost and numbers are weighted 50 : 50	66.7%	0.6%	32.7%		100.0%
Allocation on legal entity basis	35.2%	55.6%	9.2%		100.0%

If employee numbers are counted, then the allocation weights the third-party sales ratio, the employee number ratio, and the fixed asset ratio equally. The allocation of employee cost counts does the same, except it considers employee cost and not employee numbers. A third option is included where employee numbers and cost are both included and the one third share allocated to employees is itself weighted half to cost and half to numbers. This last basis is the option the EU prefers.

Now it is seen that although on an accounting basis 55.6% of profit (or $79 million) was allocated to company B just 0.6% of taxable profit (also assumed to be $142 million) would be under the EU's preferred formula. That would leave just $852,000 allocated as profit to Company B in the tax haven. Profit allocated to Company A would increase by $44.7 million and to Company C by $33.4 million, together explaining the $78.1 million fall in tax allocated to the tax haven. Tax due would as a result go up by about $23.8 million in all at the effective tax rates noted ($13,4 million in Company A and $10.4 million in Company C).

The result is obvious: tax is paid where it is due. Attempts to shift tax through transfer mispricing are countered and the abuse of tax havens is dramatically reduced. The transparency of tax due increases enormously. And curiously, states can also compete on tax rates if they wish knowing that their tax bases are secure and that it is only by increasing real sales, people employed or assets engaged that they can really draw in extra revenue. Artificial measures will not work. Substance wins over form and that is why adoption of a Common Consolidated Corporate Tax Base is so important.

General anti-avoidance principles

The legal systems in the EU member states vary widely. As a result the way in which they deal with tax avoidance also vary widely. In some member states it is clear, either from case law or from statute law that if an artificial step is put into a complex transaction for the sole or main purpose of securing a tax advantage as a consequence then that artificial step will be ignored when it comes to calculating the tax due. As example, it has been reported of Italy that[xxxix]:

> *In two decisions on December 23, 2008, the Italian Supreme Court has for the first time held that the Italian tax system contains a general anti-avoidance principle derived directly from the Italian Constitution, under which the tax administration can disregard a transaction entered into for the sole purpose of obtaining a tax advantage.*
>
> *According to the Court, the general anti-avoidance principle derives from article 53 of the Italian Constitution establishing that all must pay taxes according to their ability to pay, at higher rates for higher income. It is a general principle of the Italian tax system that applies in addition to any other specific anti-avoidance provisions of the tax code.*
>
> *From now on, any transaction that generates a significant tax benefit must be tested under this general anti avoidance rule, which requires that the transaction be entered into for significant economic reasons beyond obtaining a tax advantage, as well as under any specific anti-abuse provisions that may apply to that transaction.*

It can be argued that France has the same approach within its law[xl] as might Germany[xli]. The UK, on the other hand, has no such provision at present and is not alone in being in that situation.

Due to the dissimilarity of the law in many European Union member states and the limits of the EU's right to legislate on tax issues it is recognised that there are problems in mandating that countries should have general anti-avoidance principles on a Europe wide basis. However, it is possible that the EU and members of the European parliament may wish to encourage member states to adopt such an approach when such a principle is not in operation at this time on those states where that is the case, of which the UK is a leading example.

The aim of such a principle is to encourage individuals and companies to act within the spirit of tax law and not just within the letter of it. For example, it should rule out the ability to recategorise income as capital gains.

It is stressed that a principle and not a rule should be used: a rule pre-supposes a legal interpretation of statute; a principle is an equitable construction.

The idea behind a General Anti-Avoidance Principle is simple: if a step is added to a transaction with the sole or principal aim of securing a tax advantage (which is defined as a saving in tax) then that step in the transaction is ignored for tax purposes.
In other words, it tackles pre-meditated attempts to subvert the intention of the tax system. The principle works in two ways. Firstly it has a serious deterrent effect by creating doubt as to whether tax avoidance works. Secondly it can obviously be enforced. If that enforcement is also pursued against those who promote schemes that abuse the principle the benefit is increased as tax professionals are then subject to potential penalty for selling tax avoidance, and that significantly reinforces the deterrent effect.

For these reasons the widespread adoption of effective and widely based general anti-avoidance principles is an important part of the process of beating tax avoidance.

Accounting reform

Accounting law is within the remit of the European Union, which sets the requirements for disclosure in this area for all member states through the Accounting Directives. It is unfortunate that the Accounting Directives are currently under review, but the opportunity to make change still exists.

Country-by-country reporting is the major accounting reform needed to tackle tax avoidance, much of which is hidden in group accounts.

However, there remain issues relating to individual accounts that are of substantial significance until such time as a Common Consolidated Corporate Tax Base is agreed to be the basis for taxation. In particular, and as has been noted:

1. The International Accounting Standards Board says it has not designed its standards to ensure that proper disclosure is made of intra-group trades. As such the disclosure required, in particular, in International Accounting Standard 24 on related party transactions is very limited indeed when it comes to transactions with other group companies, meaning that by far the most important related party transactions in which most tax risk arises are never reported in the accounts of individual companies. There is something profoundly paradoxical in an accounting standard on such an issue that ignores the main issue of concern for tax purposes to which the standard relates.

2. There is a significant problem in disclosure with regard to small companies in the European Union, many of which may be used for tax avoidance but where, because of the limited rules on disclosure, especially with regard to the profit and loss account and most especially with regard to a lack of audit and the exemptions available for related party transactions significant taxation issues hiding tax avoidance may go unreported.

For these reasons it is suggested that the European Union should now amend the Accounting Directive so that any company which is a member of a group or that has an associate should disclose, without exception and irrespective of its size the following:

1. All those group companies it has traded with during the period to which its financial statements relate, without exception;
2. The value of the sales to or from each such entity and the general nature of the matters to which they relate;
3. The balances owing to or from each such entity at the year-end and the maximum sum outstanding during the year.

If this were to happen data that would disclose transactions likely to hide transfer mispricing would be substantially more readily available.

Corporate tax accounting disclosure

There are two areas of importance where change is required with regard to corporate tax accounting disclosure.

The first is, as with the previous section, firmly within the European Union's remit and relates to disclosure in financial statements. As has already been noted, if tax compliance is seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes then tax avoidance very definitely includes paying tax later than anticipated to obtain a cash flow advantage. It is in fact fair to say that a great deal of tax avoidance is of precisely this nature: the tax bill is not avoided entirely but deferred from the date when it might reasonably be expected to be due. When this is the case it is highly likely that the sum deferred will be included in what is called the 'deferred taxation liability' account on the balance sheet of the reporting company.

Deferred taxation is a widely misunderstood area of accounting. Broadly speaking deferred tax might be defined as tax that might be payable at some time in the future as a consequence of transactions that have already occurred, but with there being no certainty as to when, if, or ever that tax might be paid. That vagueness, unsurprisingly, is reflected in the quality of the decision-making companies make on disclosing their deferred tax liabilities. These they have to disclose in total, with a reconciliation being made between the year opening and closing balances including the charge made in the profit and loss account. They have also to explain the main cause for the tax being deferred, but massive discretion is given to companies on the detail in which they make this disclosure so that some major companies only disclose two or three causes for deferral and others offer many. What is never disclosed are:

1. When the liability might reasonably be expected to fall due, if at all.
2. Where the potential liabilities might be payable, and where the transactions that might give rise to that payment would actually occur. These two may be different, because as has been noted, if is quite often possible to defer tax by locating profits in a tax haven but suffer some tax if they are ever distributed to a parent company.

These issues need to be addressed by better accounting disclosure so that the effectiveness of a companies tax planning can be understood, with the object of assisting tax authorities to choose the most egregious cases that are likely to need their attention. It is coincidentally true that the same data may also be of considerable value to investors.

As a result the first necessary change to deferred tax accounting to assist the tackling of tax avoidance is disclosure of when it is anticipated that deferred tax liabilities might fall due in bands. Since all deferred tax is by definition due more than a year after the balance sheet date those bands would split the liability as follows:

1. After 1 but less than 2 years;
2. More than 2 but less than 5 years;
3. More than 5 but less than 8 years;
4. More than eight years;
5. At an unknown date.

By making this disclosure it will become obvious how much of the deferred tax liability is simply the result of those differences between the accounting and taxation treatment of some issues (most of which will give rise to short term differences) and that part which is serious planning, much of which will be heavily deferred or have no known liability date. Of course, the potential cash flow of the company will also be capable of better appraisal as a result of this disclosure so the information also has considerable value to investors. Most importantly though tax authorities will better appreciate the issue they are dealing with when assessing the tax avoidance of a multinational corporation.

That appraisal would be better undertaken if disclosure was also made, as noted above, of the split of the location where both a) the transactions giving rise to deferred tax arose and b) where the resulting tax might be paid. These need not be the same, so disclosure of both is needed. The use of offshore for deferral purposes would then be disclosed, producing both a useful deterrent effect and additional resources on which to base a tax enquiry.

Such an enquiry would, however be most greatly assisted if the European Union were to extend the definition of accounting records to include all entries relating to the preparation of group consolidated accounts including the calculation of tax and deferred tax liabilities and at the same time required that all such entries be made available for enquiry by tax authorities along with all other such records. Since the definition of accounting records appears to be within the remit of the Accounting Directives this appears to be within its scope.

If so the impact would be considerable. All the accounting entries that are eliminated on consolidation, which by definition include all intra-group transactions, together with the accounting for all tax entries, which by definition include the accounting for all tax avoidance, would then be available for tax authorities to scrutinise and challenge to ensure that companies were acting in tax compliant fashion. Since this has to be the objective standard that the governments of European Union member states demand from the multinational corporations domiciled in Europe both to ensure tax compliance and to protect investors, civil society and other states from abuse as well as to ensure that a level playing field operates within the market place such disclosure is consistent with the underlying principles of the European Union.

Codes of Conduct

Finally, of the matters to be considered that directly address tax avoidance (although some, noted below with regard to tax evasion will be seen to have significant benefits in tackling the list of tax avoidance methods noted above) is the need for the creation of Codes of Conduct for professional bodies advising on tax in the European Union. Since the EU regulates the mutual recognition of professions across the member states the inclusion of such a code of conduct in the professional standards of bodies having members who act as tax agents and advisers could be made a condition of such recognition in future.

The need for a Code of Conduct for Taxation has been extensively addressed by Richard Murphy in a paper under that title published in 2007[xlii]. The Code proposed then was intended to apply to the activities of governments, tax payers and tax agents and was reduced to a short format as follows:

Objective

This Code of Conduct relates to the payment of taxes due to a State or other appropriate authority designated by it.

Scope

This Code applies to:

1. Governments and their agencies in their role as tax legislators, assessors and collectors;

2. Taxpayers, whether individuals, corporate bodies or otherwise;

3. Tax agents, whether they are undertaking tax planning or assisting with tax compliance.

Application

It is intended that this Code be voluntarily adopted by States and should be used to guide the conduct of taxpayers and their agents who choose to comply with it whether or not they reside in a State which has adopted the Code.

The Code

The Code is divided under six sections, each of which includes three statements of principle.

1. Government

a. The intention of legislation is clear and a General Anti-Avoidance Principle ('Gantip') is in use;

b. No incentives are offered to encourage the artificial relocation of international or interstate transactions;

c. Full support is given to other countries and taxation authorities to assist the collection of tax due to them.

2. Accounting

a. Transparent recording of the structure of all taxable entities is available on public record;

b. The accounts of all material entities are available on public record;

c. Taxable transactions are recorded where their economic benefit can be best determined to arise.

3. Planning

a. Tax planning seeks to comply with the spirit as well as the letter of the law;

b. Tax planning seeks to reflect the economic substance of the transactions undertaken;

c. No steps are put into a transaction solely or mainly to secure a tax advantage.

4. Reporting

a. Tax planning will be consistently disclosed to all tax authorities affected by it;

b. Data on a transaction will be consistently reported to all tax authorities affected by it;

c. Taxation reporting will reflect the whole economic substance and not just the form of transactions.

5. Management

a. Taxpayers shall not suffer discrimination for reason of their race, ethnicity, nationality, national origin, gender, sexual orientation, disability, legal structure or taxation residence; and nor shall discrimination occur for reason of income, age, marital or family status unless social policy shall suggest it appropriate.

b. All parties shall act in good faith at all times with regard to the management of taxation liabilities;

c. Taxpayers will settle all obligations due by them at the time they are due for payment.

6. Accountability

a. Governments shall publish budgets setting out their expenditure plans in advance of them being incurred, and they shall require parliamentary approval;

b. Governments shall account on a regular and timely basis for the taxation revenues it has raised:

c. Governments shall account for the expenditure of funds under its command on a regular and timely basis.

Enforcement

States seeking to comply with the Code will voluntarily submit themselves to annual appraisal of their Conduct. These appraisals will in turn be reviewed by a committee of independent experts appointed by participating States. Differences of opinion will be resolved by binding arbitration.

Any taxpayer or agent wishing to comply with the Code may do so. A State should presume that a person professing compliance with the Code has done so when dealing with any tax return they submit. In consequence the administrative burdens imposed upon that person should be reduced. In the event of evidence of non-compliance being found any consequential penalty imposed should be doubled.

It is, of course, the case that only parts 2, 3, 4 and 5 (b) and (c) that can apply to a taxpayer or adviser, but the promotion of such codes would, it is suggested, if backed by the doubling of tax

penalties for those who choose not to comply, have significant behavioural impact, most especially on the tax profession, and it is for that reason that it is proposed here.

Summary on tax avoidance

Tax avoidance is an important issue, and for large companies more important by far than tax evasion, which few if any will knowingly participate in. Since those large companies do however have massive lobbying power that sets the scene for a great deal of tax policy tackling their tax avoidance is more important relatively speaking than the likely proportionate gains to be made in terms of extra revenue from effort expended, which will probably be higher when tackling tax evasion.

It is for this reason that it is suggested that when tax avoidance is tackled the issues to be focused upon are those that provide the 'smoking gun' to reveal which of these companies are most likely to be tax avoiding and where. This is not to ignore issues relating to personal tax avoidance, but it is fair to say that many of those issues are either decided upon at national level or are also covered by the matters that follow that tackle tax evasion, which is mainly an activity undertaken by small companies and individual taxpayers.

The yield from these tax avoidance policies are threefold. First, extra revenues will without doubt be raised. It has, for example, been conceded by a number of governments that country-by-country reporting would result in extra tax being paid. If combined with unitary taxation it is almost impossible to see how that would not be the case.

It is more than this though because secondly such measures would increase corporate transparency and disclose many of the risks inherent within the trading within the world's largest corporations. It is that risk that has lead to many recent failures of such entities. It is almost entirely hidden from view. Investors and society at large would be protected as a result, whilst the enhanced local accountability it would create would undoubtedly drive increased corporate responsibility.

Lastly, and perhaps as importantly, the process would create a level playing field where tax abuse hidden by opacity could not create an artificial competitive advantage for those willing to engage in it. The result would be that capital would then be allocated on the basis of those best able to use it, and not on the basis of those best able to abuse it. The gains to society, to honest businesses and to European market efficiency would be considerable. The goal of beating tax avoidance has to be desirable for these reasons alone.

Tax evasion

Tax evasion is, as part 2 of this report shows, substantially more important in terms of tax lost than tax avoidance and is, therefore, worthy of considerable effort to ensure that the revenues that disappear into the shadow economy are collected as far as is possible.

No one should be under any illusion that this will be easy, but such are the sums involved the task is vital. For that reason it is important that, as with tax avoidance, some of the more significant ways in which tax evasion takes place are understood. For this reason it is worth reiterating that tax evasion is the illegal non payment or under-payment of taxes, usually resulting from the making of a false declaration or no declaration at all of taxes due to a relevant tax authority or as a result of a false claim for expenses for offset against income legally declared to a tax authority which might in either case result in legal penalties (that may be civil or criminal) if the perpetrator of the tax evasion is caught.

The result is that either:

1. Income is not declared as it should be, or
2. Expenses are claimed for offset against income that are not allowed in law.

Of the two the first is by far the most significant. Indeed, the measure required to address the second issue is simple to specify, and is that if this issue is considered important more staff must be engaged in undertaking audits of taxpayers' returns and accounts submitted to a tax authority. Such audits can, of course, be assisted by computer modeling that might suggest the returns to look at that appear to include unusual expense claims, but every resulting enquiry will require staff input to bring it to fruition. This is the only way to tackle this problem. Governments, Therefore, have to decide the resources they wish to allocate to this task.

Having noted this point, the focus of attention from hereon is on undeclared income, which is the real issue of concern with tax evasion. The suppression of income to assist tax evasion can take many forms ranging from the simple payment of unrecorded cash to complex arrangements. These arrangements can, however, be split into just three broad types of tax evasion, although each can be pursued in a number of ways. The policy objectives that make it easier to undertake these activities and the broad changes to policy needed to address them are also noted in the following table before detailed proposals on how to take these matters forward are then suggested:

Type of tax evasion	Mechanism used to evade tax	Policy incentive that encourages evasion	Policy change required to address issue
1. Payment for work undertaken in cash or by barter with no	These transactions take place mainly or entirely outside the	Issuing of high denomination bank notes.	Control the issue and use of high denomination bank

record maintained of cash receipts.	formal recorded economy and either involve barter or payment in cash. Those transactions are then deliberately excluded from the accounting records of those people with an obligation to report them to their tax authorities.	Failure to monitor high value cash withdrawals from banks. Failure to monitor cash payments in some sectors such as building. Not making it a legal requirement to have a receipt for all transactions in some countries. Weak money laundering regulation and insufficient penalties on regulated sectors with low rates of reporting of suspicious cash transactions that is not being pursued by regulators of the professions involved.	notes and withdraw from use as far as possible. Make it a legal requirement to have a receipt for all commercial transactions of all sorts for both buyer and seller with vendor details fully disclosed. Improve money-laundering regulations on cash deposits and payments as well as bank withdrawals. Invest more in enforcing money-laundering regulations, especially by currently low reporting groups such as accountants. Change the focus of required accounting by small self employed businesses so that they can submit accounts with the option of claiming a flat rate deduction for expenses (as is available for VAT in some countries) but at the same time demand they either disclose their top ten customers by value in a year or they disclose their weekly sales

			takings for the year for which they are reporting to support their tax return. This will help identify falsified patterns of income disclosure and concentrate all attention on income disclosure when far too much attention is given by tax authorities at present to false expenditure claims because these are, relatively, easier to identify.
2. Criminal activity which is, by definition not reported for tax.	Income arising from criminal activity is, of course, not reported for tax purposes in most cases. That relating to areas other than tax is largely ignored here. Smuggling remains a tax driven activity. The criminalization of certain products e.g. illicit drugs means that trade associated with these activities is not taxed. Some criminal activity is intended to exploit the tax system. Value Added Tax missing trader fraud is one such activity. So are:	Weak border controls. Failure to monitor the flow of smuggled goods. Criminalisation of persistent economic activity that will not be suppressed or controlled by the penal system. Failure to control the issue of taxpayer identities to those not entitled to them. A readiness to make tax repayments without appropriate checks and balances in place. Failure to allocate	Weak border controls assist smuggling. They need to be improved. Regular outlets for smuggled goods such as market stalls, street vending, car boot sales and other such venues need regular policing. Tax authorities and police need to pursue those trading in this way, starting with identification of their vehicles as a means of identifying those supplying smuggled goods. The regulation of limited companies needs to be substantially enhanced (see next section).

	• Fraudulent tax repayment claims • Fraudulent benefit claims Any tax system has also to take into account the fact that paying tax is a way to make the proceeds of crime appear legitimate. The possibility that the tax system is used in this way as a front to legitimise money laundering of the proceeds of crime has always to be considered.	sufficient resources to tackle fraud on tax departments. The use of self-assessment tax systems. Failure to tackle identity fraud. Insufficient control of internet access to taxation systems. The failure to make tax evasion a predicate offence for money laundering makes it harder to secure prosecution of those tax evading whilst disguising other criminal activity.	They can easily be used to hide the identity of those undertaking criminal activities domestically as well as internationally. Tax repayment claims made to tax departments need to be subject to considerably more scrutiny before repayment is made than at present. They are the basis for may frauds on tax departments especially by those using false or duplicate identities. Tax evasion must be made a predicate offence for money laundering across the European Union and be used as the basis for prosecution when evidence of other crimes is hard to secure.
3. Data suppression and identity disguise.	Data suppression means that a transaction taking place in the formal financial and banking system is not declared for taxation purposes by the person benefitting from it.	The area of greatest creativity in tax evasion, by far. Banking secrecy permits data suppression. Easy incorporation	Data suppression is only possible when information is not automatically supplied by a person making payment of income to a taxpayer does not have to inform their tax authority of the

	This process can often (but not always) overlap with the use of identity disguising techniques so the two methods are considered together here. Identity disguise means that the transactions on which tax is evaded occur through the formal financial and banking system but that the identity of those undertaking them is hidden from tax authorities even if not from the bankers who facilitate them, wittingly or unwittingly.	encourages identity disguise. Failure to invest in accurate company registers permits identity abuse. Ease of dissolving limited liability entities encourages people to use them and then walk away from companies used for identity disguise. Availability of nominee directors, secretaries, shareholders and registered offices lets true ownership and control of companies be hidden from company registries, especially when coupled with banking secrecy. Trust arrangements facilitate identity disguise, whether they are used to hide the identity of a person or the ownership of a company. The failure to record the beneficial ownership of companies on public record makes identity abuse much easier.	fact that they have done so. There does, therefore, have to be the widest possible automatic supply of information on income paid to tax authorities both nationally and internationally. Both data suppression and identity disguise relate to transactions in the formal economy but which are not disclosed for tax payment purposes. If automatic supply of information on income paid tackles data suppression then notification of the beneficial ownership of accounts maintained at bank accounts is essential to tackle identity disguise. This requires a change in the culture of banking which the current financial crisis both suggest desirable and timely. This change in culture would require that banks: 1. Properly identify the sole or principal beneficial ownership of all

		The absence of any registry arrangement for trusts makes them easy to suppress for tax reporting purposes. Weak automatic information exchange between the banking sector and tax authorities both within and between jurisdictions makes data suppression easy.	accounts that the maintain as at present; 2. Be required to disclose the existence of that beneficial interest of a taxpayer in that bank account when it was opened, changed or closed and otherwise at annual intervals. 3. Partake in information exchange with tax authorities on income that they had paid to that account annually. This requirement that information be exchanged with tax authorities on income that they had paid to an account maintained for a beneficial owner that they had identified for money laundering purposes should be extended to all companies within the financial services sector making payment to individuals or other entities with regard to any income generated within the

			financial services sector. Companies making payment of dividends should be required to make disclosure of the beneficial recipients of that dividend to their domestic tax authorities. To assist the identification of beneficial owners of accounts, companies, trusts and other entities taxpayers must be issued with unique tax identification numbers that must be rigorously controlled for accuracy. To ensure that the beneficial ownership of companies and trusts is properly identified the taxpayer identity of those actually owning shares in companies, whether directly or through nominees and trusts, must be identified by taxpayer number. No company should be incorporated without its beneficial ownership having been proved to the country

			permitting its registration. No change in ownership shall be permitted without a new owner having similarly proved their identity. Existing companies should be required to prove their beneficial ownership. Nominee owners should be required to state the beneficial owner on whose behalf they act. Nominee officers of a company, identified by their agreeing to provide limited services merely to meet regulatory requirements, shall be required to disclose from whom they receive instruction when accepting their appointment. Those offering registered office services to companies shall be required to place on public record the address of the place of business of the company at which they correspond with it. A register of trusts

			equivalent to a register of companies should be maintained for all trusts that do not have an identifiable and disclosed lifetime beneficiary. No company that has failed to fulfill its regulatory obligations to file accounts should be allowed to be dissolved. In the event of a company that has a bank account, details of which have been notified, failing to meet its obligations to file accounts the bank maintaining that account shall be required to supply without objection being allowed: 1. Copy bank statements; 2. Full disclosure of the beneficial ownership information they maintain; 3. Payment in full of all ongoing penalty charges from out of the bank account they maintain for the company; 4. Such other information as is

			required to identify the owner of the entity. International cooperation to ensure effective exchange of the information described shall be pursued so that the identity of all companies shall be available not only to tax authorities but also on public record so that the privilege of limited liability is matched by the fulfillment to meet the obligations arising from it, including the duty to declare who owns the entity and to disclose what it does by filing its accounts. These measures would, in combination, have best chance of tackling tax evasion through data suppression and identity disguise.

Practical measures to tackle tax evasion

It is apparent from the above table that a significant range of measures can be adopted to tackle tax evasion. As with tax avoidance, however, priorities have to be established that are likely to yield the highest returns in the short and medium term. This section now focuses on the main such changes that can yield those returns. The focus is in each case, and to follow the over-riding theme of this report, to produce the 'smoking gun information' that a tax authority needs that has a dual benefit

of, firstly, giving that authority the data likely to prove that tax evasion is taking place, and as importantly, to discourage its occurrence by increasing the known probability of detection, so putting off potential tax evaders.

Proposed reform	The matter tackled
Invest more staff in tax audits.	The cash economy.
Reform small business tax returns.	Under-declared cash income.
Seek smoking gun data on tax evasion from other government maintained registers.	The cash economy.
Police likely outlets for smuggled goods more effectively.	The criminal economy.
Upgrade the European Union Savings Tax Directive.	Suppressed data.
Extend the geographic scope of the European Union Savings Tax Directive.	Suppressed data.
Where the European Union Savings Tax Directive cannot be applied demand new forms of more limited, but cost effective, information exchange.	Suppressed data.
Require that banks disclose the opening and closing of all bank accounts whether income is paid on them or not.	Suppressed data.
Require that company registries undertake due diligence on beneficial ownership, directors, secretaries and registered addresses.	Identity disguise.
Require that registers of trusts be maintained where trusts are permitted by law.	Identity disguise.

These issues are discussed in more depth as follows:

Invest more staff in tax audits

A culture of cuts in government spending is being applied across Europe in response to the deficits arising in the aftermath of the 2008 financial crash. This is a false economy in the case of tax authorities.

Tax authorities raise money and spend modest sums to do so. For example, the UK's H M Revenue & Customs cost just over £3.9 billion to run[xliii] with regard to its tax collection activities in 2010-11. Total tax receipts in that year were £447 billion. Now this does not, of course, suggest that the ratio of tax collected for additional expenditure incurred is 100 to 1; that would be an absurd proposition, but if the tax gap is even of the size HMRC estimate (£35 billion a year), let alone of the size Richard Murphy has estimated (£95 billion a year plus £25 billion of outstanding debt), the yield on further

expenditure would be high. The UK government itself suggested in 2010 that spending an additional £900,000 a year would raise an extra £7 billion a year in tax revenue[xliv]. The staff unions at H M Revenue & Customs think it could be higher.

This report endorses that approach of spending more to raise additional revenue at this time. In making that recommendation it is suggested that:

1. This spending should be exempted from the normal criteria for cost cutting applied to government departments at this time because it is revenue raising, not cost incurring.

2. The focus of the expenditure should be directed by collecting enhanced data on the tax gap in each European Union member state to focus attention on particular local issues of priority. That data should be published and targets set for reducing the tax gap. Every government in Europe should now be required to do this.

3. The argument that collecting tax at this time deflates an economy should be ignored.

   That argument is true if additional taxes are levied on those already paying the tax required of them by the law because that then reduces their legitimately available disposable income and so reduces consumption with a consequent impact on economic activity that can deflate the economy if the additional taxes are simply used to pay down debt. If this happens such tax collection effectively fuels the paradox of thrift that was described by Keynes[xlv].

   That deflation does not, however, happen if the additional tax revenues raised are collected from those avoiding or evading their tax obligations and these additional sums collected are used to prevent cuts rather than repay debt. If that is done then there is no deflationary effect because the spending is simply reallocated from those with no legitimate right to enjoy the benefit of that spending (because they are spending from stolen or illicitly obtained funds) to those with that legitimate right to enjoy the benefit of those funds because the government has directed the benefit of their use to them in accordance with both the law and its democratic mandate to enforce its tax collection rights.

   Alternatively, this deflationary effect does not occur if the additional revenues are used to reduce the taxes due by those already tax compliant.

   In either of these cases there is no deflationary consequence of this tax collection but there is a significant increase in respect for the rule of law, trust in society, business confidence as all businesses will be operating on a level playing field and so, in turn, in legitimate economic activity.

As a result this spending on tax collection should be seen as part of a much broader economic approach to promoting growth that will in itself tackle budget deficits. That is why it is essential.

Reform of small business tax returns

Small businesses indisputably evade tax. Not all of them do of course, but if there is one section of the economy where tax evasion is most likely then all tax authorities agree that the small business sector is it. In the UK H M Revenue & Customs have estimated that 46% of small businesses under-declare their tax[xlvi] and this is one of the more tax compliant countries in the European Union. As noted already, a small part of this will be because those businesses claim expenses to which they are not entitled but the majority will be because they suppress their earnings.

Current mechanisms of accounting may assist this process. Whilst spending in small business accounts is usually extensively analysed, meaning that trends are relatively easy to spot and so unusual items can be identified and be enquired about, the sales figure in a set of accounts is often just one number with little or no further elaboration provided. The consequence is that too little attention is focused on this much more sensitive number when it comes to tax evasion. This is illogical, especially when most small business accounts are prepared solely to assist the settlement of tax liabilities.

To tackle this issue, and at the same time advance the agenda of making life in general easier for small businesses requires reform to the way in which tax authorities require small businesses to account to them so that information on the most critical sales line is the focus of that reporting whilst reducing reporting obligations in other areas.

The suggestion made is, therefore, that all small unincorporated businesses (for this purpose those probably turning over less than €1 million a year) should be required to submit with their accounts a breakdown of their sale turnover. Firstly they should disclose their top ten customers by value, plus the total of 'other' sales. If those exceeded 70% of sales then no further analysis would be needed. If they did not then either their monthly, or in the case of business categories where cash revenue is most likely, their weekly sales revenues for the year would also need disclosure. This requirement could, of course, be extended to limited liability entities as well.

Those self employed people (only, this could not apply to limited liability companies) with sales of less than €100,000 might get compensation for this effort by being allowed to claim a fixed rate deduction for their expenses, with that rate being set by business category. Such arrangements are already implicitly in force in some VAT accounting schemes and will as a result have been widely tested for credibility and accordingly could readily be extended to income taxes as well. If the result was prejudicial to the business the option of submitting full accounts would, of course, still be available.

The benefits to business are obvious. Many now use software for accounting and producing this data should therefore be easy but it would immediately show:

1. Those self-employments disguising what are in reality employments, as they will only have one dominant customer. The status of these self-employments could then be challenged and this tax avoidance activity could be stopped. This is an area of widespread abuse, often with regard to payroll and social security taxes.

2. Patterns of billing could be identified. It is remarkably hard to falsify records persistently when seasonal trends in many businesses are very consistent. Those not conforming to such trends could then easily be identified as those likely to be presenting falsified data and be the subject of enquiry.

This change in emphasis in disclosure is likely to substantially increase identification rates for both tax avoidance and evasion and better focus tax authority effort on those most likely to be abusing whilst at the same time offering a valuable simplification to small business in an area where losses to false claims are overall likely to be much lower than losses arising from suppressed sales income.

Seek smoking gun data on tax evasion from other government maintained registers

Governments maintain extensive databases. Some can be used to indicate those likely to have wealth. These should be correlated with tax return data to indicate those people where inconsistencies appear to exist.

This has recently been done in Italy. As the Daily Telegraph newspaper[xlvii] in the UK reported in January 2012:

> *Tax officials traced the owners of 133 Lamborghinis, Ferraris, SUVs and other top-end cars that they found parked in the snow-lined streets ofCortina d'Ampezzo, a winter playground for the rich and famous in the Dolomites.*
>
> *They found that 42 of the owners – nearly a third – had declared incomes of less than 22,000 euros (£18,000) a year. A further 16 claimed to be earning less than 50,000 euros a year.*
>
> *The investigation, in Italy's answer to St Moritz, highlights a nationwide problem of Italians cheating the tax man by hugely under-declaring their incomes or declaring no income at all.*
>
> *The spot checks were carried out by a team of 80 officers from Italy's inland revenue agency, who said it would be almost impossible to run a top-of-the-range BMW or Porsche on such modest salaries, at a time when a full tank of petrol for a high-performance car can cost 180 euros.*

This was a small sample check. The check could, of course, have been done systematically across the entire database of car ownership for almost any country.

The same could also be undertaken for other assets, and most especially land.

In addition, yacht registries might be investigated.

Taking the logic just a little further, and perhaps as importantly, credit rating data could be used to check for inconsistences between taxable income reported to tax authorities and income claimed for other purposes, plus credit allowed. Of course credit rating data is not perfect, but no source of data is.

What is important is that it is widely known by tax evaders that conspicuous consumption may lead to tax enquiry. That is the key point, and it has the sole aim of creating a deterrent effect. This can be achieved by using the chosen data selectively and then heavily publicising results. That may, of course, have been the aim of the Italian action noted above. If so, the attention it received justified the effort involved. It is a policy that should be copied, widely.

Police likely outlets for smuggled goods more effectively

More widely defined criminal activity is not the focus of this report, but that criminal activity which is directly tax related is a matter of concern.

Smuggling remains widespread in Europe and remains viable solely because the goods smuggled can reach consumer markets. The outlets involved are often, but by no means exclusively, on the edges of the formal economy (such as small shops and market stalls) or are in the informal economy e.g. what are called 'car boot sales' in the United Kingdom and which have variants in other European Union countries.

These activities need better policing if smuggling is to be tackled. As reports on tobacco smuggling in the UK have shown[xlviii], this is possible in part by tackling manufacturers to make sure that goods such as cigarettes do not enter the illicit market in the first place. These actions may have halved the scale of cigarette smuggling in the UK, but organised crime remains an issue that requires other countries to take similar action. It has been noted to the author of this report that Ireland, where such measures have not been taken, now has tobacco smuggling at twice the UK rate.

In addition, and whilst maybe of lower value in terms of tax recovered, action has to be taken against the outlets for these products. This requires high profile police and tax official presence at events where products are likely to be sold for cash, and systematic monitoring of vehicles attending such events to provide the evidence that leads to identification of those systematically distributing smuggled products. The relationship between crime and tax evasion is real and only visible policing will stop it.

Upgrade the European Union Savings Tax Directive

As the European Union itself notes[xlix]:

> *Income from interest on capital is one of the most mobile tax bases, and tax competition is rife. In order to ensure the proper operation of the internal market and tackle the problem of tax evasion the savings tax Directive was adopted in June 2003. It has been applicable since 1 July 2005.*
>
> *The Directive applies to interest paid to individuals resident in an EU Member State other than the one where the interest is paid. Member States had to transpose its provisions into national legislation.*
>
> *The European Commission on 13 November 2008 adopted an amending proposal to the Savings Taxation Directive, with a view to closing existing loopholes and better preventing tax evasion.*

The European Union Savings Tax Directive has worked within the limits of its original remit. In effect that remit meant that information on income paid by a bank or other financial institution in one EU (or signatory) state to a person resident in another EU state had that income paid automatically declared to the tax authority of their home state unless the tax deduction alternative was applied instead (see below). This was a direct, and effective, assault on tax evasion with a significant deterrent effect in some cases, as automatic information exchange always has.

However, that remit was too limited. The directive's current limitations are fourfold. Firstly, only interest payments are covered, leaving out dividends and royalties.

Second, only payments to individuals (or natural persons) are covered, omitting companies and trusts (legal persons).

Third, it is limited geographically to the EU, although equivalent measures have been established in separate treaties (multilateral or bilateral) with 15 additional jurisdictions enjoying close ties to the EU (a total of 42 jurisdictions).

Fourth, Luxembourg and Austria (and at one time Belgium) negotiated a transitional exclusion from the automatic information exchange process by substituting a withholding tax of currently 35% (from July 2011) on the interest payments to the concerned non-residents. They share the revenue with the country of residence of the account holder, with the latter receiving 75 percent of the total. The same withholding tax provision has been agreed with eleven of the 15 non-EU jurisdictions, including Switzerland, though this agreement is not considered transitional.

To tackle these limitations the European Union has been seeking to upgrade the European Union Savings Tax Directive, as was always envisaged from the time of its first introduction. As they say with regard to that review[l]:

> *The European Commission on 13 November 2008 adopted an amending proposal to the European Union Savings Directive with a view to closing existing loopholes and better preventing tax evasion. The Commission proposal seeks to improve the Directive, so as to better ensure the taxation of interest payments which are channeled through intermediate tax-exempted structures. It is also proposed to extend the scope of the Directive to income equivalent to interest obtained through investments in some innovative financial products as well as in certain life insurance products.*

The upgrade is currently being blocked by Luxembourg and Austria who are demanding to be treated on a level playing field with Switzerland[li], and by Italy who think Switzerland have too much influence over the proposal. The upgrade is, however, vital because it extends the scope of the income covered quite considerably so that most products of the financial services industry are covered (but not dividends and royalties) but more importantly, so too are companies and trusts, where the income will be declared as if it belongs to their beneficial owners, which it is assumed all financial intermediaries know as they are required to do so by money laundering regulation.

The impact of this change would be substantial. First the amount of tax collected would increase, without doubt, but more importantly, offshore secrecy would be shattered in many locations because of the way in which the upgrade is worded. The impact would be that many tax havens (including Switzerland, Liechtenstein, Jersey, Guernsey, the Isle of Man, Cayman and others) would lose their element of secrecy for European Union citizens, and this is essential to their current trade and appeal. That is why the Tax Justice Network defines tax havens as secrecy jurisdictions. Secrecy jurisdictions are, it says, places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so.

This is why the European Union Savings Tax Directive upgrade now requires urgent support so that it takes place and tax evasion is much more effectively tackled as a result.

Extend the geographic scope of the European Union Savings Tax Directive

The European Union has not only said it wishes to upgrade the European Union Savings Tax Directive, it also wishes to extend its geographic scope. There is clearly significant advantage in doing this and as such any move in this direction is to be welcomed. However, prospects do appear limited at present.

Demand new forms of more limited, but cost effective, information exchange

The purpose of the European Union Savings Tax Directive is to create automatic information exchange on income received to act as a deterrent to tax evasion. This is highly effective for two reasons. Firstly the mere existence of such arrangements is a deterrent to those planning to evade. Secondly it provides a 'smoking gun' that provides information to a tax authority on income received if the taxpayer does not declare the income, so making it easier to start an enquiry into their affairs.

The difficulty of the European Union Savings Tax Directive approach to automatic information exchange is that it is difficult to define certain sorts of income (e.g. royalties and dividends) and that it is, undoubtedly, expensive to compile information in the form that the European Union Savings Tax Directive envisages. The arrangement may well work in the countries in which it currently applies but there is obvious and significant advantage to extending it more widely and to more tax havens. It is for that reason that Richard Murphy has suggested an alternative form of more limited information exchange arrangement that is, however, intended to achieve the same goals[lii].

The key concern when tackling international tax evasion is the use of offshore financial structures such as trusts, companies and foundations. Because of the limitations in the European Union Savings Tax Directive there is at present no automatic information exchange with regard to such structures within the EU, let alone elsewhere at present. The automatic information exchange arrangements that currently exist relate only to interest income paid to accounts held in individual's names. This is a serious weakness: it is relatively easy, and cheap, to set up trusts and corporate structures that can hide this tax evasion from view.

However, the precise details of interest, profits, gains or other income accruing to these types of offshore structures created by, owned by, or which benefit people resident within EU jurisdictions is not needed to enable EU member states to make an effective enquiry under a tax information exchange agreement of a tax haven that makes such structures available for the use of EU citizens. All an EU member states needs to know to make an enquiry about the tax affairs of one of its residents under one of the increasing common tax information exchange agreements with tax havens is:

1. That an offshore structure exists (a bank account qualifying by itself as a structure for this purpose, but so too does a company, trust or foundation or any combination of them);
2. What each component (trust, company, or foundation) in the arrangement 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 network of Tax Information Exchange Agreements now being promoted by the Organisation for Economic Cooperation and Development[liii].

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 these offshore / tax haven structures are located; with that location where the beneficiary is located to be identified by both the place of their main residence and by the country which issues them with their passport.

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

There is a further advantage in that the technical processes involved to exchange this sort of information would be relatively straightforward to resolve compared to those required to exchange data on income.

With this data the OECD promoted Tax Information Exchange Agreements (which work on the basis of specific enquiries about specific taxpayers being made) become meaningful: the 'smoking gun' required to make them useful would exist if information exchange of this sort were to take place. Nothing could achieve this more quickly or cost effectively than this proposal.

There does, however, remain the problem of negotiating the necessary thousands of such tax information exchange agreements, all of which would 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 readily suitable multilateral agreement in operation at present although the OECD have expressed interest in that option.

If the EU were to promote such a standard alongside the OECD the world of offshore would suddenly lose much of its opacity and a major step towards cracking open offshore tax evasion would have been taken.

Require that banks disclose the opening and closing of all bank accounts whether income is paid on them or not

There are already, and largely unknown to most people, extensive information sharing agreements in place within and between EU members states so that income earned on bank accounts is shared by those banks with the countries that host their activities and in turn through them with other EU member states. This is obviously welcome, as are other information sharing arrangements in operation in the European Union: their contribution to tackling tax evasion has never been properly measured but they all undoubtedly help. However, as has been continually noted in this report, opportunities for abuse still exist.

When undertaking research on the regulation of limited companies in the UK referred to in the next section of this report[liv] Richard Murphy became aware that there is a major loophole in this information sharing. In the UK at least if no taxable income arises as a result of the operation of a bank account (i.e. no interest is paid) or if that bank account is run for a limited company and other such entities then no information sharing takes place with a tax authority. It seems that the same deficiencies are common throughout Europe. This creates the absurd paradox that data is available on the accounts of some individuals but never on the entities most commonly used to hide their identities when tax evading. Given that the civil rights issue of information sharing has already been resolved in that information sharing has taken place on the interest earning bank accounts of individuals for many years the principle of extending that information sharing to other bank accounts must be capable of straightforward agreement.

This suggests that another form of 'smoking gun' information exchange is now vital, and this is that all banks must now report to both their tax authority and their official government company registrar whenever they open or close a bank account for a person within their country of operation (or, indeed, elsewhere, so that the information might be shared as well). The information they would need to supply would be:

1. The date of the event;
2. Whether an account was opened or closed;
3. Who the account was opened or closed for;
4. In the case of a person, what their identified address is and their tax identification, including registration numbers for income tax and social security purposes and passport number or driving licence number if available. This is, of course, simple since they have to undertake due diligence of this sort for money laundering anyway so the additional cost burden is tiny;
5. If the account was for a limited company, partnership or other entity what is registration number is, where the registered office is and where the entity is considered to trade plus, if anyone held an interest of more than 5% in it, who that beneficial owner was with all identification details as noted above for an individual for each such person;
6. At the end of each year the total sum of deposits into and out of the account during the course of the tax year.

The risk that bank accounts might then go unnoticed is very low and given the data requested on turnover accounts for investigation could then be easily identified. Of course there is a risk of misleading data on turnover e.g. resulting from bank transfers, but the opportunity to enquire has to be made available in a simple way and this data does that.

There is a more significant benefit however. This arises in particular with companies with whom all contact is lost, as seems commonplace in the UK at least where more than 300,000 companies were dissolved for this reason alone in the year 2009-10[lv]. In these cases having access to this banking data means that:

1. It will be known if the company has traded or not and therefore whether there need be concern about contact being lost;
2. If it has traded and contact has been lost then contact can be made with its bank instead;
3. Costs with regard to taxes and penalties can then be recovered from the bank in question;
4. Action to recover tax can also be taken against known people identified by the bank at their known addresses, which is usually not possible at present.

This one change therefore shatters much of the identity disguise currently going on in domestic economies at present. It is entirely within the right of the European Union to recommend action on this issue.

Better regulate company registries

Companies are commonly used to hide the identity of a person who is trading. As the Economist noted recently[lvi], this should not be the case: it was always intended that the names and addresses of those managing and owning companies be stated on public record so that responsible management was encouraged but this principle has been widely undermined in recent years. This has happened because:

1. The cost of incorporating companies in some jurisdictions has become very low. In the UK it is commonly much less than £100[lvii];
2. There is no legal duty placed on a company registration agent or on official government company registrars to identify by due diligence of the standard required for money laundering purposes those who claim to:
    a. Own shares in a limited company;
    b. Direct a limited company, or
    c. Act as company secretary of a limited company.

    As a result it is all too easy for false data to be recorded.

The problem has been exacerbated by three further tendencies:

1. A desire on the part of governments to deregulate, believing that this is to the benefit of business;
2. Cuts in the resources made available to official government company registrars as part of the general culture of cuts;
3. A lack of willing to prosecute these failing to comply with required standards in some jurisdictions resulting in a culture of voluntary compliance with regulation at a time when the number of companies in use is rapidly expanding in states where labour force liberalisation is encouraging labour contracting.

As a result, as research in the UK (which has more companies than any other jurisdiction in the EU) has shown[lviii], large numbers of companies do not meet their obligation to file records as required by law and in 2009-10 alone more than 500,000 companies were dissolved without any formal process of liquidation taking place, without up to date asset and liability statements being made and with more than 300,000 of these dissolutions happening simply because all contact had been lost between the UK Registrar of Companies and the company (although it should be said that a loss of contact simply means that letters had not been replied to; no further effort was made beyond sending reminders).

The result is clear indication of a company register that is out of control, something that has become commonplace since the audit requirement for small companies has been abolished, in the process removing the involvement of professional advisers in the affairs of many small companies.

As a result of this ongoing failure the incorporation of limited companies does appear to have become for some at least something little more than an opportunity to undertake licenced identity theft by hiding behind a disposable façade of limited liability. Those appearing to use limited companies in this way do not meet their obligations in company law and, as the same research showed, also fail to file the tax returns demanded of them (more than 700,000 companies failed to file the tax returns requested of them by H M Revenue & Customs in the UK in 2009-10[lix], and that was after that agency had decided, without much apparent evidential base to not demand returns from more than 800,000 companies[lx] even though many fewer than that had self declared themselves to not be trading in submissions made to the UK's Registrar of Companies.

These consequences arise:

1. Substantial tax revenues are lost. Richard Murphy has estimated that this might be £16 billion a year in the UK, although it is stressed the figure can only be an estimate;
2. The privilege of limited liability is being systematically abused. It is stressed that no one has a right to limited liability: it is a privilege granted by statue (as the Economist also noted recently)[lxi] in exchange for the obligation to:
    i. Comply with regulatory demands including filing documentation and accounts on public record;
    ii. Pay tax due.

3. The business environment is being harmed. If, as seems possible based on HMRC data noted previously, 46% of small businesses run by individuals underpay the tax they owe and based on Richard Murphy's research up to 38% of trading companies in the UK and more than 56% of all companies in the UK do not file tax returns and therefore in all likelihood also fail to pay the tax they owe a culture of tax abuse is rampant in the small business sector that undermines the competitive advantage of honest small businesses that comply with their regulatory obligations and pay their taxes.

   The failure of government to support the honesty and competitiveness of these businesses by allowing a criminogenic environment to develop in the small business community is a massive failure on its part to support honest small businesses. It also discourages investment, training and the development of a long-term business view as business risk is increased significantly when honest business is threatened by those companies and individuals who systematically break the law. This has significant impact on any economy so afflicted, as recent evidence has shown.

As a result is now essential that the European Union demand that the company registers of Europe be properly regulated and that this be evidenced by changing the information that must be placed on public record by all Europe's private limited companies. It is now vital that those registers record:

1. The beneficial (and not just the legal) owners of all interests of more than 5% in these companies. That would mean that all nominee relationships would have to be disclosed, as would the ultimate beneficial ownership of all groups of companies if the company making a return was a subsidiary of a group and that the beneficial ownership or control of trusts owning such interests would also have to be disclosed (see below re trust registries). Only in this way can it be known who controls limited companies.

2. All directors must declare if they either a) act on the instructions of others, in which they must declare who those other people are or b) have either actual or de facto arrangements in place meaning that their resignation could be recorded by another person at any time, in which case the identity of that other person must be declared since they have effective control of their position in that case. In this way nominee directorships would be disclosed.

3. The same arrangements should apply to company secretaries as for company directors.

4. The actual place of business of the company must be recorded on public record as well as its registered office. This address would be identified as the place at which the directors effectively receive communication from their bankers, even if it is not the address to which the bankers initially send that correspondence.

5. The identity of the company's main bankers (as identified in accordance with the previous main recommendation) should be disclosed on public record.

With this data on public record, plus the information on banking previously recommended, the opportunity to undertake identity disguise will be greatly reduced and so tax evasion will be cut considerably.

All companies trading in a jurisdiction, which would include those owning real estate in it plus those distance selling into it and undertaking investment activity within it, would be required to place this information on public record as well as those incorporated in the jurisdiction in question.

The abolition of abbreviated accounts, which are intended to create market opacity, should be undertaken at the same time.

When doing so it should be stressed that this whole agenda is being promoted to reduce business risk and to lower as a result the cost of capital for those engaging in trade by encouraging a level playing field for all businesses on which competition takes place on price within the market place and not on the basis of who is willing to abuse regulation most, as is the case at present. As such these reforms are fundamentally pro-market and to oppose them would be to adopt an anti-market position.

Registers of trusts

Trusts have been used for many decades in some EU member states to hide the identity of the owners of companies and other assets. Indeed, by combining a trust with a company de facto banking secrecy as secure as anything Switzerland can offer can be created in many locations. This is clearly unacceptable.

That said it has to be recognised many trusts are created for completely legitimate reason and there is no public concern about them. Almost invariably these are trusts created by an identifiable settlor for the benefit of named people and there is no discretion provided to trustees about the interest of all these people in the trust in question, which then solely becomes a mater of concern to tax authorities, not all of whom it has to be said know of such arrangements.

On the other hand, those trusts (and the relatively similar foundations in states where trusts are not usually permitted) where it is hard to identify settlors let alone beneficiaries are matter of considerable concern to tax authorities and the public at large if they disguise the ownership of companies, for example, meaning that people are left without knowledge of who they are really dealing with and therefore suffer consequent increased risk of being defrauded.

As a result it is clear that registration of all operative trusts is needed to ensure that identity disguise is not taking place but that if the trust is of the first sort noted then less information is required than if it is of the second sort.

There should then be recorded on public record similar to a Company Registry:

1. The name of the trust, its date of creation, the address at which it can be contacted and the name of its bankers;
2. A broad summary of the trust's objectives. The trust deed would not be required.
3. The identity of the settlor. If a nominee has been used they must declare that fact as they would have to if a company director in the proposal for company disclosure made above;
4. The names and addresses of the trustees. If they are nominees those on whose instructions they act (including settlors, their layers and enforcers) must be disclosed;
5. A statement that the trust had appointed beneficiaries and that all the income and capital of the trust had to eventually be distributed in accordance with the trust deed without discretion being allowed. If this was the case then no accounts would be required on public record.
6. A list of all known actual or potential beneficiaries in support of the previous statement.
7. If the statement in (5) could not be made then a list of all those who had benefited from the trust in the previous five years should be disclosed together with the trusts accounts, to be presented annually within nine months of their year end.

Enforcement of this disclosure would be simple: the property in unregistered trusts would be deemed to be that of trustees and be taxed on them, giving settlors every incentive to comply with initial registration. Failure of trustees to comply thereafter would mean that the property in the trust would be declared that of the sate, albeit to be distributed as far as possible as the trust deed suggested if that potential distribution could be identified, but if not to be forfeited. Again, the pressure to comply would be very strong indeed.

As a result of these simple rules the use of trusts for identity disguise would be eliminated, trusts would no longer be unknown to tax authorities and tax evasion would be reduced considerably.

Endnotes

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[iii] http://www.irs.gov/businesses/article/0,,id=180259,00.html

[iv] Eurostat online data codes nama_gdp_c and tec00001 for 2010

[v] See World Bank data at http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal) accessed 11.11.11 (as were all documents noted)

[vi] See http://en.wikipedia.org/wiki/List_of_countries_by_population

[vii] See here http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/10/14/000158349_20101014160704/Rendered/INDEX/WPS5356.txt table 3.3.6. Average data was used.

[viii] See http://www.heritage.org/index/Explore.aspx?view=by-variables

[ix] See http://www.heritage.org/index/Explore.aspx?view=by-variables

[x] http://www.who.int/whosis/whostat/EN_WHS2011_Full.pdf

[xi] http://fms.treas.gov/intn.html#rates and specifically http://fms.treas.gov/intn_12312010.pdf End 2010 data was used as most GDP and other data was for that year.

[xii] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-26042011-AP/EN/2-26042011-AP-EN.PDF

[xiii] http://www.hmrc.gov.uk/stats/mtg-2011.pdf

[xiv] http://www.taxresearch.org.uk/Blog/2010/09/12/the-tax-gap-why-hmrc-have-to-be-wrong/

[xv] http://www.irs.gov/newsroom/article/0,,id=252038,00.html

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[xix] http://www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf

[xx] Based on 2006-07 data here http://www.hmrc.gov.uk/stats/tax_receipts/tax-nic-receipts-info-analysis.pdf excluding VAT and other duties not considered by the report

[xxi] http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/foot_review_deloitte.pdf

[xxii] http://www.hmrc.gov.uk/stats/mtg-2011.pdf

[xxiii] http://www.hmrc.gov.uk/stats/measuring-tax-gaps-2010.htm.pdf

[xxiv] http://www.hmrc.gov.uk/stats/measuring-tax-gaps.pdf

[xxv] http://www.taxresearch.org.uk/Blog/2011/09/21/the-tax-gap-why-hmrc-have-to-be-wrong-2/

[xxvi] http://www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf

[xxvii] http://www.tuc.org.uk/economy/tuc-17311-f0.cfm

[xxviii] http://www.hmrc.gov.uk/aiu/guidance-august-2011.pdf

[xxix] http://www.hmrc.gov.uk/aiu/guidance-august-2011.pdf

[xxx] http://www.taxjustice.net/cms/upload/pdf/45940CCBd01.pdf

[xxxi] http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html accessed 27-4-09

[xxxii] http://www.taxresearch.org.uk/Documents/Where4Art.pdf

[xxxiii] http://visar.csustan.edu/aaba/ProposedAccstd.pdf

[xxxiv] http://eitransparency.org/

[xxxv] A revision to IFRS8 on Segment Reporting could achieve this objective. See http://www.iasplus.com/standard/ifrs08.htm for a description of the current inadequate standard or http://www.taxresearch.org.uk/Documents/IAS14Final.pdf for a discussion of its inadequacies.

[xxxvi] http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

[xxxvii] http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf article 86

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[xl] Articles L. 64 et seq. of the Livre des Procédures Fiscales quoted at http://www.fitindia.org/downloads/Ned%20Shelton_2004.pdf

[xli] Sec 42AO 42 of the General Tax Code quoted at http://www.fitindia.org/downloads/Ned%20Shelton_2004.pdf

[xlii] http://www.taxjustice.net/cms/upload/pdf/AABA-TR-Code_long.pdf

[xliii] http://www.hmrc.gov.uk/about/annual-report-accounts-1011.pdf page 78

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[vi] http://www.economist.com/node/21543164
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