# Tax Evasion and Avoidance Schemes

Alexander Ezenagu

# Taxation

- What is a tax?
  - A financial levy imposed either on economic activities or acquisition of wealth?
  - General or specific purpose? Difference between taxes and fees (licences, levies)
- Why do we tax?
  - To raise revenue; to distribute income; influence behavior; influence the economy;

# Tax Evasion and Tax Avoidance

- What is tax evasion?
  - OECD: a term that is difficult to define but which is generally used to mean illegal arrangements where liability to tax is hidden or ignored, I.e the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities
  - Canada Revenue Agency: deliberately ignoring a specific part of the law.
  - It is adjudged to be illegal and criminal and tax evaders face prosecution in criminal courts.
- What is tax avoidance?
- OECD: a term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.
- Canada Revenue Agency: all unacceptable actions taken to minimize tax, while within the letter of the law, those actions contravene the object and spirit of the law

# What is BEPS?

- “tax planning strategies that exploit loopholes in tax rules to make profits disappear for tax purposes or to shift profits to locations where there is little or no real activity but where they are lightly taxed, resulting in little or no overall corporate tax being paid.”- OECD Centre for Tax Policy and Administration
- The shifting of profits, from countries where multinational groups conduct active business operations, through deductible payments to “hub” companies that the groups have established in tax havens- Mike Durst of ICTD
- G20 St Petersburg Declaration 2013, Tax Annex
  **“International tax rules, which date back to the 1920’s, have not kept pace with the changing business environment”**
  **“... will be examined to ensure that profits are taxed where economic activities occur and value is created.”**
  **“more transparency... including through a common template for companies to report to tax administrations on their worldwide allocation of profits and tax”**

# Paradise Papers

- Paradise Papers: the hidden costs of tax dodging (https://www.oxfam.org/en/even-it/paradise-papers-hidden-costs-tax-dodging).
- OXFAM: Tax havens fuel inequality and hold back the fight against poverty. This simply has to stop.
- Africa's Satellite' Avoided Millions Using A Very African Tax Scheme (https://www.icij.org/investigations/paradise-papers/africas-satellite-avoided-millions-using-african-tax-scheme/).
- Tax Haven Mauritius' Rise Comes At The Rest of Africa's Expense (https://www.icij.org/investigations/paradise-papers/tax-haven-mauritius-africa/).

# Paradise Papers (contd.)

- Paradise Papers reveal how tax havens damage Africa (https://www.dw.com/en/paradise-papers-reveal-how-tax-havens-damage-africa/a-41321485).
- The Paradise Papers show how Africa's elite avoid taxes abroad as they do at home (https://qz.com/africa/1122267/paradise-papers-bukola-saraki-sam-kutesa-ibrahim-mahama-ellen-johnson-sirleaf-and-sally-kosgei-named-in-leaked-documents/).
- Paradise Papers: Everything you need to know about the leak (https://www.bbc.com/news/world-41880153).

# ICIJ: Paradise Papers Senegal

- One Company's Tax 'Heaven' Is Senegal's Tax 'Hell' (https://www.icij.org/investigations/west-africa-leaks/one-companys-tax-heaven-senegals-tax-hell/).
- Canada-based company signed a deal to build a processing plant for the Grande Cote mineral sands mine in Senegal.
- The plant was built by SNC-Lavalin-Mauritius, a subsidiary of the Canadian parent company.
- Senegal has a 20% WHT on payment of technical service fees. However, the Senegal-Mauritius tax treaty reduces this to zero percent tax rate.

# TRANSFER PRICING EXPLAINED

- Intra-firm trade accounting for more than 60% of world trade
- This necessitates the pricing of goods transferred among related entities- based on the current international tax system
- Transfer pricing defined as prices set by an MNE for the sale of goods and services between two entities controlled by the MNE.
- Transfer mispricing is the manipulation of transfer prices to minimize tax liabilities.
- Other reasons for transfer mispricing include: improvement of wage bargaining with local labour units, exchange rate and nationalization risks; circumvent restrictions to the transfer of profits from those host country(ies) which pose strict ceilings and constraints to such transfers. See Grazia Letto-Gilles ( **Transnational corporations and the globalization process)** and Roger Wesley (Problems in Regulating the Multinational Enterprise—An Overview)

# Tax Avoidance from Cross-Border Activities between Associated Enterprises

- "Where

  a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

  b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

  and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprises and taxed accordingly."

- Does Article 9 refer to allocation of profits of companies or does it seek to allocate transfer prices?
- Are the TP methods price-based or profit-based?

# Application of Transfer Pricing Guidelines

- Ambiguous Status of OECD TPGs
  widely adopted 1996- , not only by OECD members, almost universal
  Only "soft law" in most countries, but widely applied in practice
  Deeply embedded in professional-technical practices, but easy to amend
  Ad hoc methodology & complexity allows flexibility
  Depoliticises issue of allocation of MNE profits
  Yet continual rise of conflicts & disputes: MAP & Arbitration -- in secret

- Implementation in Africa
  Statutory power to adjust to "arm's length" profits – almost all countries
  Specific Regulations based on OECD TPGs: 17 states -
  Egypt (2005) , Kenya (2006), Namibia (2006) , Rwanda (2007) , Senegal (2008), South Africa (2009), Malawi (2009) , Uganda (2011), Ghana (2012), Nigeria (2012), Madagascar (2014), Tanzania (2014), Seychelles (2015), Liberia (2016), Zimbabwe (2016), Mozambique (2017), Zambia (2018)

# Problems of Transfer Pricing

- Major practical problems
  Individual "facts & circumstances" functional analysis & comparables search
  Need for expert knowledge: asymmetry between Revenue & Taxpayer
  Subjective: creates uncertainty & conflict
- Basic conceptual flaws
  Separate entity concept illusory: whole is more than sum of parts, profits from synergy
  Key functions centralised: Finance, R&D, Risk - major problems for ALP

# Some Transfer Pricing Cases

- Unilever Kenya (2005)
  under statutory powers, no Regulations
  Adjustment to CUP, taxpayer wanted Cost+, TPGs not mentioned in Kenya law
  Court: TPGs are international standard, "I do not smell" tax evasion
  Regulations 2006; KRA creates enforcement teams 2011
- Karuturi Flowers (2013)
  2012-13 dispute, appeal, settlement.
- Eastern Produce Malawi (2018)
  Audits 2014, disallowed services fees 4% of turnover, based on TPGs
  Application for judicial review on grounds TPGs not law in Malawi
  Court: Revenue should apply law, TPGs only guide to interpretation
  If taxpayer charges disallowed RA must specify alternative.

# Socio-economic Implications of Transfer Pricing Abuses

- Taxation is key to the character and functioning of the state, the economy and society as a whole- Solomon Picciotto
- Denial of basic economic, social and cultural rights of African countries.
- Shifts the tax burdens to individuals, who are the poor ones.
- Erodes inter-nation and inter-taxpayer equities.

# Attempts at Improving the Global Tax System

- BEPS project and beyond
  Aim to align profits & tax with real economic activities
  but Actions 8-10 focus on "misuse" excluded study of alternative approaches.

  Revised TPGs 2017: start from contracts, but analyse "real deal"
  e.g. for intangibles DEMPE functions
  Result: TPGs 450 >> 600 pages, "far more complex" (Andrus & Collier 2017)

  Achievement: country-by-country reporting (CbCR) + Master File + Local File

  Profit Split Method – still "transactional", some new examples
- OECD Policy Note: …"solutions that go beyond the arm's length principle

# Short-Term Solutions

- Brazil: Fixed Margin System 1998: Sol Picciotto

Based on OECD Cost-Plus & Resale Minus methods
but fixed margins (3 bands for imports used in manufacture), +/- 5%
taxpayer can only choose among available methods, not e.g. TNMM

Right to appeal to Minister – never used

Compatible with art. 9 but not TPGs

Easy to administer, few disputes, predictability for investors
but one-size-fits all, fixed margin regardless of actual profitability
corporate tax revenues quite high, tax/GDP ratio = average of OECD

# Alternative Corporate Minimum Taxes: Michael Durst

- Alternative minimum tax is computed as some small percentage (for example, 1 percent) of taxpayer's total revenue (turnover). If the alternative tax is higher than the taxpayer's regular tax liability, minimum tax is paid.
- A means of limiting base erosion and profit shifting (BEPS).
- Currently, AMTs based in whole or in part on turnover are in effect in about 18 countries, especially in francophone Africa. Rates and other details of the tax, however, vary widely from country to country (with, for example, the tax subject to low maximum amounts in some countries).
- Question for today: Is the turnover based AMT a promising model for further consideration?

# Example of Turnover-Based AMT at 1%

- Assume local subsidiary with $100 million turnover, reporting net operating margin of 3%, yielding net operating income of $3 million. Assume also that subsidiary deducts interest at 30% of net operating income, so taxable income = $2.1 million. Assuming corporate income tax rate of 35%, "regular" tax is $735,000.
- Alternative minimum tax at 1% of turnover = $1,000,000
- Additional research surely should be conducted, using data from tax returns, but it seems plausible that even a 1% alternative minimum tax based on turnover could generate better revenue results than the current BEPS-vulnerable system.

# Economic Argument Against Turnover-Based Taxes

- Taxes on gross revenue subject investors to risk taxation even in absence of economic profit; therefore, they can be seen as economically inefficient.
- But does the arguable economic inefficiency of, say a 1% tax on turnover outweigh the advantages of efficient and effective revenue collection? See Best, Brockmeyer, Kleven & Spinnewijn, "Production versus Revenue Efficiency with Limited Tax Capacity: Theory and Evidence from Pakistan," 123 Journal of Political Economy 1311 (2015).

# Potential Advantages of Turnover-Based AMT

- Since no deductions are allowed, a gross-based AMT is immune to avoidance through the overstatement of deductions. This includes immunity to avoidance through interest deductions, as well as deductions for management fees and the cost of goods sold.
- (The turnover-based AMT would remain vulnerable to underpricing of outbound sales of goods and services, including natural resource and agricultural products -- but the quantitative effects of the underpricing should be small compared to the effects under net-income taxation.)
- A turnover-based AMT should be relatively easy to administer.
- Might a turnover-based AMT result in revenue collections at levels that are politically realistic given the pressures of tax competition for inbound investment?

# Safe Harbours

- Definition:
  - Administrative simplification regime for a category of taxpayers or transactions;
  - Election between accuracy and simplicity.
- Purpose:
  - Administrative simplicity and efficiency; reduction of compliance cost and burden; reduction of risk of dispute and potential litigation risks; and promotion of FDI.
  - Securing corporate income tax revenues- guarantee of a minimum of tax revenues.
  - Tax certainty.
  - Promotes equitable treatment of taxpayers in an industry or engaged in similar transactions, unlike APAs.

# Concerns with Adopting Safe Harbours

- 1995 TPGs
  - Pre-determined prices or TP methodology may not comply with the arm's length principle.
  - unilateral safe harbor may create room for double non-taxation.
  - Tax optimization opportunities for MNEs.
- OECD, Multi-Country Analysis of Existing Transfer Pricing Simplification Measures, 2012. Influence on the OECD's take on Safe Harbours.
- OECD- SHs can help to relieve some of the burdens associated with administering and complying with the TP rules, while providing taxpayers with greater certainty.

# Types of Safe Harbours

- Exemption from Transfer Pricing Rules: Mexico (small individual taxpayers); UK (SMES, subject to some exceptions).
- Exemption from Transfer Pricing Documentation: in some jurisdictions, applied as a de minimis rule.
- Prescription of pre-established transfer method and margin rates.
- Exemption for SMEs: determining threshold; SMEs in Africa largely do not come under the TP rules as they do not engage in cross-border activities with related entities.
- Exemption for Small Transactions: issue of threshold.

# Substantive Safe Harbours

- Sectoral APAs:
  - What is an APA?
  - Difference between a sectoral APA and sectoral Safe Harbour Regime?
- Sectoral Safe Harbours
  - Determining the sectors: EU Report (applied to large sectors of the economy).
  - Determining the transfer pricing method to be applied.
- Examples of Sectoral Safe Harbours
  - Mexico: Maquiladora industry.
  - Dominican Republic: Hospitality industry.

# Country Experiences: India

- Safe Harbours
  power to create 2009
  study 2012: focus on "development centres" in 1100 locations
  2013 Safe Harbour rules
    defined sectors, specified margins
    taxpayer must opt-in
    renounce recourse to MAP, but must document transactions
    very little take-up
  2017 scheme revised – lower margins (but still probably unacceptable to taxpayers)

# Design of Safe Harbours

- Safe Harbour Transfer Pricing Methodology
  - A one-sided method is recommended.
- Safe Harbour Price Range and Interest Rate
  - Approximates to the arm's length price, else it becomes an incentive.
- Participation in the Safe Harbour Regime: Opt-in or Opt-out
  - Safe harbour regime must be voluntary.
  - Acceptable alternative(s) where a taxpayer refused to opt in or opts out.
- Unilateral, Bilateral or Multilateral Safe Harbours
  - Fear of double taxation vis-à-vis exigency and expediency.
  - Fear of capture by the bigger party.
  - Surmounting the hurdles of a multilateral agreement.  Possibility of an East African Safe Harbour Regime?

# Radical Reforms?

- Tax consequences of digitalisation of the economy
- BEPS Project Action 1: 2015 report
  not separate sector, whole economy - needs comprehensive solutions
  Task Force on Digital Economy work extended to 2020
  possible interim measures (not recommended)
- TFDE Reports to Inclusive Framework on BEPS
  Interim report 2018, Policy Note January 2019
  proposals by US, UK, France-Germany, G24 (esp. Ghana,India, Colombia)
  Consultation March, Work Programme May 2019, Final Report 2020
- Wider Permanent Establishment (PE) definition (taxable presence)
  Significant Economic Presence
- Global Minimum Tax
  Franco-German proposal (income inclusion rule + tax on base-eroding payments)
- Rules for Allocation of Profits
  New criteria for value creation (for "non-routine" returns):
  - UK: user contributions
  - US: marketing intangibles

# Unitary Approach

- Discussion here is primarily focused on the commodities industry. Commodities here is given an expansive meaning to include the extractives sector, agricultural sector, manufacturing sector and other tangible goods sector
- Unitary Taxation- Formulary Apportionment
- Separate Entity + Formulary Apportionment, e.g. Canada
- Unitary Taxation + other allocation formulas
- Focus here is unitary taxation + Formulary Apportionment
- Thus, Unitary Approach= Unitary Taxation + Formulary Apportionment

# What is Unitary Approach?

- This approach considers a Multi-national Enterprise (MNE) as a single business, which, for convenience, is divided into purely formal, separately-incorporated subsidiaries. Under this approach, the global income of the MNE needs to be computed, then such income is apportioned between the various component parts of the enterprise by way of a formula which reflects the economic contribution of each part to the derivation of profits.

- Recognizes that the relationships between members of the MNE group are governed predominantly by control, not by legal contract.

# Arguments for Unitary Approach

Sol Picciotto:

"A unitary approach would replace three major elements which create fundamental problems for taxation of TNCs under the ALP: (i) the need for detailed scrutiny of internal accounts and pricing and for the negotiation of adjustments based on the ALP; (ii) the need to deal with profit-shifting within the firm, especially using tax havens, by complex anti-avoidance measures, such as rules against thin capitalization, controlled foreign corporations, and abuse of treaty benefits; and (iii) source and residence attribution rules."

- Michael Durst:

"The adoption by a country of a formulary approach to income apportionment would appear to offer a more reliable means of curtailing base erosion, particularly over the long term, than attempting to apply a mixture of politically vulnerable, and often only partially effective, anti- avoidance measures")

- Unitary taxation entails the treatment of all the legal entities of an MNE as a single entity and required to submit one set of master accounts, including one final income and profit statement, for the purposes of taxation.
- Demands combined reporting, based on a template for both worldwide consolidated accounts and country-by-country data on revenue, physical assets, employees and sales

# Arguments against Unitary Approach

OECD:

- a move away from the arm's length principle would abandon the sound theoretical basis on which the arm's length principle is founded;
- threatens the international consensus, thereby substantially increasing the risk of double taxation;
- requires substantial international coordination, consensus on the predetermined formula and composition of the group;
- the use of pre-determined formula for all transactions as against a case-by-case formula determination, which it finds arbitrary

# Theoretical Support: Hymer's Theory of FDI and MNE

- Prior to Hymer, Ronald Coase (1937) had asked the question "why do firms exist?". He established the transactions cost theory, which was latter further developed by McManus, Buckley and Casson as the "Internalization theory"
- Hymer's theory of FDI and MNE- introduced the reason for the MNE structure and foreign direct investments by MNEs; also distinguished between purely financial investment (i.e. from portfolio investment) and investment by large firms for production purposes); focused attention upon the MNE as the institution for international production, rather than international exchange.
- **Hymer's determinants of FDI: removal of competition; advantages which some firms possess in a particular activity.**
- **Important feature: ownership and control of their assets; internalization of trade**
- direct production and generally direct business activities abroad-accompanied by the ownership of assets in at least one foreign country (Grazia Letto-Gillies: The Theory of the Transnational Corporation at 50+).
- **Control: ownership control and/or management control**
- **Hymer called for the establishment of international organizations, and some kind of global governance to regulate the operations of MNEs- is unitary taxation the global governance Hymer envisaged?**

# Textual Suggestion for the New Allocation Approach

Amendment of Articles 7 and 9 of Model Treaties

- **"where it is established that entities in a group are managed, controlled or owned directly or indirectly by the same persons and they engage in commercial or financial relations, then the consolidated profit of the group will be apportioned among the related entities on the basis of their economic activities and contribution to the group profit, using pre-agreed factors and formula."**

# Issues with the Unitary Approach

- Establishing the Unitary Business
  - What is a unitary business?
  - Which parts of the business are included for unitary taxation purposes?

- The Formula:
  - What should be the Factors?
  - How should the Factors be Weighted?

# Unitary business:

Evidence of:

- concert for the benefit of the parent company; or
- that the subsidiary acts as agent of the parent company to achieve the set expectations of the parent company; or
- the entities are committed to a single economic enterprise; or
- established for a common purpose,

then the parent company and its subsidiary should be treated as a single firm

- U.S. case of Butler Bros: the court held a unitary business to be present where there is: (1) unity of ownership; and (2) unity of operations, such as joint purchasing, advertising, accounting and management.
- Unity of ownership goes to the legal relationship between the entities in a corporate group. The unity of operations refers to the economic relationship between the entities.

# The Apportionment Formula

- The Canadian System
  - As a general rule, Canada applies a two-factor formula of sales and payroll with each weighted equally.
- The United States System
  - Massachusetts Formula, Double Weighted Sales Formula or Single-Sales Factor Formula

  Common posited formula: Massachusetts Formula (assets, labour and sales in equal proportion)
- Factors and weight to be adopted in the apportionment formula stem from a policy choice, and not from a precise measurement of the contribution of each related entity to the global profit
- The focus should be on arriving at a formula which ensures that taxable profits, commensurate to their contribution to the global profit of the corporate group, are declared and returned in their jurisdictions.

# Factors

- Assets: divided into tangible and intangible assets.
- Recommendation: exclude intangible assets from the formula (nebulous with respect to location, benefits and protections furnished by the state and the social costs incurred; can be included in other factors)
- Labour: divided into payroll and headcount (ideal considering wage disparities). Also, place of work and not place of employer.
- Sales: origin-based sales and destination-based sales. What is ideal for African countries, which have relative small purchase power? An equally-weighted origin-based plus destination-based factor?

# Choice and Weighting of the Factors

- Call for single-factor unitary approach, usually sales factor- Avi-Yonah, Eichner, Clausing…
- In addition, in a lot of cases, the assets and labour which produce the goods to be sold are located in African countries, and a sale-only factor will only lead to the continuous exploitation of the resources of these countries, without commensurate return.
- An equally-weighted three-factor approach will ensure that countries like Nigeria attain a just allocation of the income, due to it.

# Two Scenarios: Arm's Length Principle

- Suppose Parentco A, resident in Canada, is engaged in the manufacturing of bags and owns 100% of the shares in a Nigerian company, Subco B. Its assets and factories are located in Nigeria. Of its 3,000 global employees, 2,700 of those employees work for the Nigerian subsidiary, Subco B and are resident in Nigeria for tax purpose. Suppose Parentco A has a subsidiary in the Netherlands, Subco C, who is responsible for its marketing, management, financing affairs of the group and owns the rights to both the tangible and intangible assets of the group. Under the current tax system, it is conceivable that most of the total profits will be declared in the Netherlands, even though the income may actually be realised in Nigeria, where the real economic activities occur.
- Treating each entity as separate from each other means that every exchange of value has to be priced and the price transferred to an entity. This creates the opportunity to erode tax bases by interposing artificial entities for the purpose of avoiding tax, while also fixing transfer prices that may not be arm's length.

# Scenario 2: Formulary Apportionment

- Using the scenario above and assuming the group made total profit of $9,000,000 for the financial year. Splitting the profit into three equal parts- $3,000,000 to assets, $3,000,000 to labour and $3,000,000 to sales. Nigeria, being the location of all the assets (assuming all assets of the group are in Nigeria) will be allocated the $3,000,000 for assets. Given that 90% of the labour of the group is in Nigeria, Nigeria will further receive additional taxable profit of $2,700,000 (assuming labour is purely on headcount). Without accounting for sales (assuming sales is on the basis of destination and not origin), Nigeria will be allocated a total taxable profit of $5,700,000 out of the group's total profit of $9,000,000.
- Recall that under the current system, most of the total profit of $9,000,000 could easily have been declared in the Netherlands, if prevailing literature and common knowledge are to be trusted. Nigeria stands to be in a better position under the unitary taxation treatment of multinational groups. While this scenario and the calculations are simplistic, the conclusion agrees with the available literature on unitary taxation and formulary apportionment (Sikka and Murphy 2015; Siu, et.al 2015; Li 2002).

# Questions…