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# **INTERNATIONAL TAX COOPERATION**

**Perspectives from the Global South**

**Edited by Manuel F. Montes, Danish and Anna Bernardo**



**INTERNATIONAL TAX COOPERATION**  
**PERSPECTIVES FROM THE GLOBAL SOUTH**

**Editors**

**Manuel F. Montes, Danish and Anna Bernardo**



*International Tax Cooperation*

*Perspectives from the Global South*

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## **ABOUT THE SOUTH CENTRE**

In August 1995 the South Centre was established as a permanent intergovernmental organization of developing countries. In pursuing its objectives of promoting South solidarity, South-South cooperation, and coordinated participation by developing countries in international forums, the South Centre has full intellectual independence. It prepares, publishes and distributes information, strategic analyses and recommendations on international economic, social and political matters of concern to the South.

The South Centre enjoys support and cooperation from the governments of the countries of the South and is in regular working contact with the Non-Aligned Movement and the Group of 77 and China. The Centre's studies and position papers are prepared by drawing on the technical and intellectual capacities existing within South governments and institutions and among individuals of the South. Through working group sessions and wide consultations, which involve experts from different parts of the South, and sometimes from the North, common problems of the South are studied and experience and knowledge are shared.



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## PREFACE

A substantive reform of the global tax system involving a variety of multilateral platforms is underway. The question is not whether the tax standards and practices will change, but in which direction.

Developing countries have long sought changes in rules, standards and procedures shaping the allocation of taxing rights among sovereign states. Developing countries have long hosted the subsidiaries of multinational companies. In sharing the taxing rights over these companies which are overwhelmingly headquartered in developed countries, developing countries sought to change the dominant tax conventions' procedures that strongly protected the taxing rights of rich countries. These proposals were successful only in a piecemeal fashion and as suggested alternatives to the overarching Organisation for Economic Co-operation (OECD) Model Tax Convention which are agreed standards among the 34 sovereign states – all developed countries – of the OECD. Developing country proposals were maintained mainly in the United Nations (UN) Model Double Taxation Convention. When they followed standards contrary to the OECD convention, developing countries risked being seen as a less important destination by foreign investors. While many developing countries have been included in various lists as 'tax havens', in the experience of developing country tax authorities they have found developed country facilities to be the most haven-friendly for taxpayers seeking to evade paying taxes locally.

Developed country governments came on board the agenda of a more thoroughgoing reform in the wake of tax scandals which engulfed their societies and polities in the midst of the Great Recession of 2008-2010. In the wake of the Great Recession, these governments engaged in massive public sector layoffs and channelling enormous public resources to bail out large financial companies and their wealthy investors. The Panama Papers, the Paradise Papers, the Lux Leaks became household words in the United States and Europe because of the journalistic coverage. Other scandals, such as the "cum/ex" fraud in Germany involving a loophole in the taxing of dividend receipts were less well known but just as materially significant and embarrassing to public authorities. There was also a diplomatic and treasury row between the United States and Switzerland over the secrecy facilities of the latter's banks which was resolved with great difficulty between the two

countries. The large ‘tech’ companies, including Google and Apple, which had enjoyed positive public reputations, were found to be avoiding enormous tax liabilities in places where they operated by moving their profits to and through low tax jurisdictions such as Ireland and the Netherlands.

Tax reform, particularly as it applied to the treatment of corporations working in multiple tax jurisdictions, thus became not only a problem of developing countries but an issue of global concern.

The OECD Base Erosion and Profit Shifting Project (BEPS) has become an important venue for these reform discussions. The work of the UN’s Committee of Experts on International Cooperation in Tax Matters, while only an expert body, has garnered new intense interest on the part of developing country governments and international civil society because of its more representative character. Various bodies of the European Union have become active in adjudicating, analyzing, and making proposals on tax reform. Regional tax administration forums in Latin America and Africa became very active participants in these efforts.

In November 2016, the South Centre launched the “South Centre Tax Initiative” (SCTI), a project to build a network of tax officials and experts from the South to advance the interests of developing countries in the current global effort at tax reform and combat against illicit financial flows. The South Centre is an intergovernmental think tank of, for and by developing countries. It currently has 54 Member countries. The current chairperson of the South Centre Board is former South African President Thabo Mbeki who led the high level panel which introduced the term Illicit Financial Flows as an object of multilateral attention. Under this initiative, the South Centre has convened two global fora, attended by over 60 tax officials from developing countries. The South Centre provides the secretariat for this network building project.

The main objectives of the South Centre Tax Initiative are oriented to guarantee that the ongoing global reform process goes in “the right direction”:

(1) To upgrade the capacity of developing country authorities in researching the design of effective tax policies for their own countries drawing on lessons and experiences from the developing country context;



(2) To strengthen and better coordinate developing country engagement with and negotiations in international tax cooperation activities such as in the OECD-Group of Twenty (G20) processes, the UN tax cooperation work, and regional cooperation activities; and

(3) To establish international tax cooperation mechanisms among developing country authorities, for arriving at agreed norms and mutual action at the regional and global levels.

It is important to underline that drawing lessons from the developing country context will be critical if the ongoing process of global tax reform is to benefit developing countries and achieve substantial success. OECD-preferred standards have not only proven disadvantageous to developing country tax rights, at the basic level they are quite impractical and unenforceable. The need for example, to utilize “comparable transactions” for the purpose of auditing pricing decisions of transactions among related firms as required by OECD is unfeasible in developing countries whose economies do not have the variety of firms and transactions accessible to developed and industrialized countries. Innovations to such price determination which are workable and protect their interests have been introduced by developing countries, but the OECD does not recognize these or considers these as inferior practices.

This publication is an outcome of this project based on contributions from developing country officials. It is part of an effort to create international literature among the practitioners of tax policies and administrations from developing countries to share the technical content of developing country innovations within the international tax community. Most of the articles in this collected volume come from developing country officials, though the publications programs will also welcome contributions from some academics or civil society.

Each of the chapters, which have been peer reviewed, is an analysis of a particular case or issue in order to draw lessons from experiences on tax reform which may be useful for other developing country officials and practitioners around the world and promote tax cooperation.

In this initial offering of such case studies, we include:

- a review of BEPS from a Brazilian expert, including the areas where Brazilian practice already fulfils or exceeds BEPS proposals
- an Indian analysis of the interaction of transfer pricing and profit attribution, based on the interaction between OECD and UN models
- an Argentinian review of transfer pricing concepts and practices on the lines of the “Sixth Method” pioneered by Argentina
- a study on the recent Indian experience on the exchange of information
- a South African analysis of transfer pricing audit challenges in Africa and the need to strengthen domestic legislation
- the conceptual and practical issues relating to illicit financial flows
- an exposition and analysis of the longstanding Brazilian definition and treatment of tax havens
- Ecuador’s new policies in its efforts to reduce the harms from tax havens
- a review of the state of thinking and research on the pressing issue of tax reform and tax cooperation and its gendered impacts

The South Centre is pleased to publish these studies on developing country tax reform policies for the consideration of developing country officials (especially those in their tax policy-making and administrations), of the broader international community of tax experts and professionals, and of the global community of development experts and practitioners.

Dr. Carlos M. Correa  
Executive Director  
South Centre

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**Algresia Akwi-Ogojo** is currently the Executive Director of the Uganda Land Alliance. Ms. Ogojo has more than 20 years of experience in development work within the non-governmental sector in Uganda and several countries in Africa; and has worked with the East African Community Secretariat and Legislative Assembly as Capacity Building Coordinator and Project Coordinator respectively. Algresia was appointed onto the International Board of Directors of ActionAid International as the Africa Regional Director, becoming the first woman to occupy that office and first ever African to sit on that Board. She had previously worked for the same organization in the ActionAid Uganda Country Programme as Director of Programmes. Algresia was appointed the first Regional Coordinator of and established Akina Mama wa Afrika's (AMwA) Uganda based African Women's Leadership Institute, AMwA's Africa program at the time. Algresia completed the United States Agency for International Development's (USAID) Leadership and Advocacy for Women in Africa (LAWA) program as a Women's Law and Public Policy Fellow at Georgetown University Law Centre, Washington D.C. where she received

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**Alexandre Akio Lage Martins** is a tax auditor at the Brazilian Federal Revenue Secretariat (RFB). After an initial period in customs and auditing, he is currently a member of the International Taxation Division, engaged in interpreting, reviewing and improving both Brazilian double taxation treaties and the list of tax havens. He is also a delegate to Working Party 11 of the Group of Twenty (G20)/ Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Project, which is now responsible for monitoring the implementation of recommendations for Hybrid Mismatch Arrangements (Action 2), Controlled Foreign Companies (Action 3), Interest Deductibility (Action 4) and Mandatory Disclosure (Action 12). With an academic background built on three different continents, Alexandre recognizes the important contribution of multilateral fora to reach consensual solutions for cross-border problems, especially in tax matters.

**Dr. Manuel F. Montes**, Senior Adviser on Finance and Development at the South Centre in Geneva, was previously Chief of Development Strategies, United Nations Department of Economic and Social Affairs (UNDESA). Before that, in UNDESA, he was Chief of Policy Analysis and Development and Secretary of the United Nations (UN) Committee of Experts on Cooperation in International Tax Matters; United Nations Development Programme (UNDP) Regional Programme Coordinator, Asia Pacific Trade and Investment Initiative, Sri Lanka; Programme Officer for International Economic Policy at the Ford Foundation in New

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**Thulani Shongwe** is head of resource mobilization and multilateral cooperation at the African Tax Administration Forum (ATAF). Mr. Shongwe is responsible for ATAF's project on Base Erosion and Profit Shifting (BEPS), the ATAF Technical Committee on Cross Border Taxation (CBT) and is a member of the Organisation for Economic Co-operation and Development (OECD) Working Party 6 on the Taxation of Multinational Enterprises and a member of the United Nations (UN) Sub Committee on Tax Base Protection.

**Dr. Vinay Kumar Singh** is a Commissioner in the Indian Revenue Service, and has been part of the Indian tax administration for over 23 years. His assignments include being an expert faculty on international taxation in the National Academy of Direct Taxes and other institutions, a member of the Indian team negotiating tax treaties and mutual agreement procedure (MAP) disputes, and as Indian Representative in the Organisation for Economic Co-operation and Development (OECD) and other multilateral institutions. He was a member of the Working Party – 1 of the Committee on Fiscal Affairs of OECD dealing with the Actions 6, 7 and 14, and the Task Force on Digital Economy dealing with broader challenges of taxing digital economy (Action 1) during the Base Erosion and Profit Shifting (BEPS) Project undertaken by the Group of 20 (G-20) and OECD. He has also been an OECD Expert Faculty on property taxation. Dr. Singh has a Masters in Public Finance as well as a Masters in Public Administration to his credit and has been undertaking individual research in these areas, as well as matters related to international taxation and tax policies. He has also been a member of Committees appointed by the Central Board of Direct Taxes in India for the simplification of income-tax and for the taxation of e-commerce.

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**Prof. Dr. Marcos Aurélio Pereira Valadão**, Doctor of Juridical Science (S.J.D.) (SMU, Dallas, TX, US); Master of Laws (UnB, Brazil); LL.M. in International and Comparative Law (SMU, Dallas, TX, US); Expert Degree in Tax Administration (PUC-GO, Brazil); Post-Doctorate Research in Law (UnB, Brazil) is Professor of Law at Catholic University of Brasília (UCB) (International Taxation and Constitutional Tax Law). He is the former Brazilian representative to the Committee of Experts on

International Cooperation in Tax Matters of the United Nations (UN); current Member of the Subcommittee on Transfer Pricing of the UN Tax Committee; former International Relations Coordinator of the Federal Brazilian Revenue Secretariat (RFB); former President of the 1st Section of the Federal Administrative Court of Tax Appeals (CARF); and RFB Tax Auditor currently working at the International Relations Division, dealing with tax treaty negotiations and related issues. He is also the Brazilian Representative at the South Centre Tax Initiative Steering Group. He is the author of several books and articles on taxation and international tax law published in Brazil and abroad.

**Monica Victor** is former Senior Programme Officer of the Sustainable Development and Climate Change (SDCC) Programme of the South Centre. She has been a Tax Attorney for the Ministry of Finance of Brazil for 25 years. She obtained her LLM in International Law and Economic Integration from the State University of Rio de Janeiro and her LLM in International Organizations with Emphasis in International Economic Organizations from the University of Zurich. She is an SJD Candidate at the Graduate Tax Program, University of Florida. She was elected Vice-Chair of the American Society of International Law (ASIL) Teaching International Law Interest Group, and appointed for the ASIL Investor-State Dispute Settlement Working Group Steering Committee.

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# CHAPTER 1

## INTRODUCTION

Danish, Manuel F. Montes, Daniel Uribe, Monica Victor

In 1990, the South Commission clearly identified tax reform as one of the challenges facing the Global South, noting that “The amount of tax revenue a government can raise is clearly dependent on the productivity of the economy and is also influenced by its own administrative capabilities.”<sup>1</sup> Over 25 years later, the Addis Ababa Action Agenda also recognized that “domestic resources are first and foremost generated by economic growth, supported by an enabling environment at all levels.” But the scale of the challenges has increased manifold in the intervening years, and, as it was famously observed, achieving the Sustainable Development Goals (SDGs) would require a movement from “billions to trillions”.<sup>2</sup>

Attaining the 17 SDGs and 169 Targets under the 2030 Agenda for Sustainable Development requires countries to mobilize revenues at the domestic level, including through effective collection of tax revenues. States need to enhance their tax base, while simultaneously preventing resource flight through illicit financial flows (IFFs). This is most acute in the case of “commercial IFFs”, with estimates suggesting that quantitatively, commercial activities account for 65 per cent of IFFs. According to the United Nations (UN) High Level Panel on Illicit Financial Flows from Africa led by former South African President Thabo Mbeki, these “commercial IFFs” include practices such as “abusive transfer pricing, trade mispricing, mis-invoicing of services and intangibles and using unequal contracts,

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<sup>1</sup> South Commission, *The Challenge to the South* (Oxford University Press, 1990), p.124.

<sup>2</sup> Development Committee, “From Billions to Trillions: Transforming Development Finance, Post-2015 Financing for Development: Multilateral Development Finance”, Discussion Note (2 April 2015). Available from [http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002\(E\)FinancingforDevelopment.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002(E)FinancingforDevelopment.pdf).

all for purposes of tax evasion, aggressive tax avoidance and illegal export of foreign exchange”.<sup>3</sup> Therefore, for enhancing resource mobilization in developing countries, one must positively consider the views of the UN Secretary-General when he notes that, “more effective taxation of large businesses, including multinational enterprises, can boost revenue, while contributing to perceptions of fairness in tax systems and reducing inequality.”<sup>4</sup>

The early 20<sup>th</sup> century saw an unprecedented easing of the ability of capital, goods and services to flow across international borders. This was accompanied by a proliferation of double taxation treaties (DTTs) since at least the 1920s, which allocated taxing rights among countries and provided them with specific jurisdiction to tax income or capital. Now, with globalization and the global operations of multinational enterprises (MNEs), taxation and its regulatory frameworks have gained intrinsically global dimensions.

The rise in cross border e-commerce transactions is also bringing forth new issues, such as the shift towards a service-based digital economy and use of intangibles, with their associated fees and royalties. The adoption of platforms and advertisement driven business models, along with fundamental questions on value addition and characterization of income for tax purposes have disrupted entrenched rules and provided MNEs with new avenues to indulge in aggressive tax planning activities. Such schemes generally include MNEs being able to shift their profits to offshore jurisdictions where they would pay little to no taxes on their income.

Thus, there is a pressing need for a multilateral recognition of the differences in the ways that developing and developed countries treat companies, especially MNEs operating in their territory. The pressure to project a stable and attractive environment for foreign

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<sup>3</sup> *Report of the High Level Panel on Illicit Financial Flows from Africa*, p.24. Available from [https://www.uneca.org/sites/default/files/PublicationFiles/iff\\_main\\_report\\_26feb\\_en.pdf](https://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf).

<sup>4</sup> United Nations Economic and Social Council (UN ECOSOC), Note by the Secretary-General, Financing for Sustainable Development, E/FFDF/2019/2, 11 March 2019, para. 32.

investment on one hand, and the need to obtain positive benefits from incoming investment on the other shape the tax policies of developing countries to a great extent. These two imperatives lie at the heart of the challenges that developing country tax authorities face in drafting their domestic policies and negotiating with other states on the allocation of the taxing rights over such economic actors.

These developments are imposing substantial losses for developing countries in their efforts to mobilize revenue domestically. The emergence of new technologies and the digitalization of the economy are the big challenge for revenue authorities, requiring the creation of an entire new set of tax rules which will be equitable and cognizant of the developmental needs of emerging economies. These rules will also need to ensure that a fair share of taxes is paid by the enterprises and industries, including those benefiting from a digitalized economy, to the jurisdictions where they make their profits. It is equally important that the profits generated are not shifted out of the country using illicit means. Corporate income taxes are crucial for developing countries, as for them it “frequently amounts to over 25 percent of total revenues”,<sup>5</sup> and at “about 20 per cent of total taxes, they are nearly twice as important as for developed countries”. According to the United Nations Conference on Trade and Development (UNCTAD), corporate taxes yield two thirds of all income taxes in developing countries, while it is only a quarter in developed countries. Thus, as a share of gross domestic product (GDP), corporate income tax amounts to “almost 4 per cent of GDP in developing economies against 2 per cent in developed economies”.<sup>6</sup> Estimates also suggest “revenue loss to developing countries from profit shifting at 1.3 percent of GDP, which is much larger than for OECD countries”.<sup>7</sup>

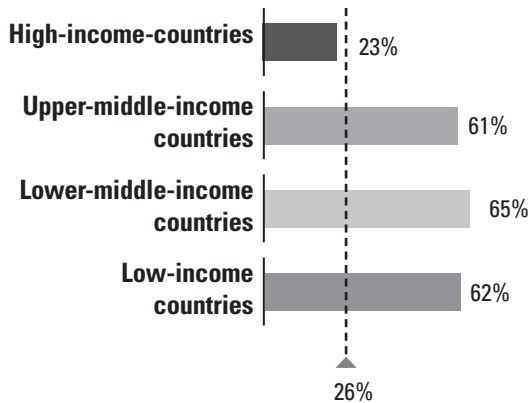
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<sup>5</sup> Rueven S. Avi-Yonah, “Hanging Together, A Multilateral Approach to Taxing Multinationals”, in *Global Tax Fairness*, Thomas Pogge and Krishen Mehta, eds. (Oxford University Press, 2016), p. 114.

<sup>6</sup> *UNCTAD World Investment Report 2015*, p. 181.

<sup>7</sup> International Monetary Fund (IMF), “Corporate Taxation in the Global Economy”, Policy Paper No. 19/007 (10 March 2019), p. 54.

**Share of corporate income taxes in total income taxes**



Source: Adapted from Figure V.4. Key patterns in the composition of government revenues related to income levels (Per cent) in UNCTAD World Investment Report 2015, p. 183

The interest of countries, especially developing countries, in seeking a more effective and just regime of international taxation has been hampered by several challenges in the current international framework, which is itself based on rules that emerged almost a century ago.<sup>8</sup> This has led to the recognition and a global consensus on the much needed reform of the international tax regime to update it and make it relevant again for countries and taxpayers.

Although the competing claims over taxing rights include a broad range of issues, the choice between “source” or “residence” taxation system remains the main controversy when allocating taxing rights and income among developing and developed countries. Having “source”-based taxation is often critical for developing countries for taxing profits generated within their territory, while residence-based

<sup>8</sup> See Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation*, p. 19. Available from <https://www.taxjustice.net/cms/upload/pdf/Picciotto%201992%20International%20Business%20Taxation.pdf>.

taxation would allow countries where the enterprises are “resident” or incorporated, which are usually developed countries, to impose taxes. This balance is decided by the DTTs existing between the countries, which are generally based on the United Nations (UN) Model Convention<sup>9</sup> or the Organisation for Economic Co-operation and Development (OECD) Model Convention,<sup>10</sup> with the former favoring the retention of greater “source country” taxing rights. For countries to use taxation as a critical tool for financing development and eradicating poverty, they need to have the sufficient policy space to implement taxation policies for maximizing domestic finances. These treaties are therefore intricately linked with the ability of countries to generate revenue for their sustainable developmental efforts.

Within this context, developing countries also face a broad range of challenges, from abusive tax planning to transfer mispricing, commercial illicit financial flows and harmful tax competition, among others. These challenges are also embodied in the diverse minutiae of domestic tax laws, articles in double taxation treaties, implementing regulations, and procedures and practices that establish the environment within which developing country tax authorities must operate. In response to this, developing countries have introduced many innovations and alternative procedures which are often at variance with regulations and practices in developed countries.

Although certain initiatives, such as the Base Erosion and Profit Shifting (BEPS) project, launched in September 2015 under the umbrella of the Group of 20 (G20) and OECD, recognized the existence of a need of reform, they have not considered some of the most critical needs of developing countries and fall short at increasing developing country participation over the standard setting and

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<sup>9</sup> United Nations Model Double Taxation Convention between Developed and Developing Countries, 2017. Available from [https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT\\_2017.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf).

<sup>10</sup> OECD Model Tax Convention on Income and on Capital, 2017. Available from <https://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm>.

decision-making in international tax policy, despite being touted as a global tax reset.

The current international tax framework has exhibited a strong tendency to ignore and not recognize developing countries' experiences and innovations in tax policy and administration. For instance, in the ongoing efforts on global tax reform, issues having a high priority for developing countries, such as the tax treatments of extractive industries and of technical services, have not been adequately reflected in the international agenda or in multilateral tax discussions.

While the BEPS Project was supported by G20 countries and OECD members, the process of how its "package of measures" including the BEPS minimum standards, were arrived at has come under scrutiny and criticism, as they were developed without the participation of the very countries which are now being encouraged to implement them. The BEPS Inclusive Framework,<sup>11</sup> which was set up for reviewing and monitoring the implementation of the whole BEPS Package now includes 129 members (as of March 2019),<sup>12</sup> nearly three times the number of members who participated in the original discussions for deciding the measures and minimum standards.

In addition, there are also questions on whether these OECD-led standards would reinforce existing developing country disadvantages. Some critics have also pointed out how the actions points are too narrow in scope, and concentrate too heavily on rich country interests, without challenging any of the underlying principles of the system.<sup>13</sup>

Thus, there is an urgent need of a thorough reform of the international system, and this can only be achieved with the full and

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<sup>11</sup> OECD, About the Inclusive Framework on BEPS. Available from <http://www.oecd.org/tax/beps/about/>.

<sup>12</sup> OECD, Membership of BEPS Inclusive Framework. Available from <https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf>.

<sup>13</sup> For instance, see Irene Burgers and Irma Mosquera Valderrama, Corporate Taxation and BEPS: A Fair Slice for Developing Countries?, *Erasmus Law Review* (2017). DOI:10. 10.5553/ELR.000077.

secure participation of developing countries in both agenda-setting and norm-setting. International tax cooperation will therefore have to play a vital role in ensuring that developing countries are not excluded from the discussions at the regional and multilateral levels.

In response, the South Centre has launched a major effort to build a working network among developing country officials that will highlight practical solutions emerging from developing countries and strengthen their participation in international fora and in standard setting negotiations. The South Centre Tax Initiative (SCTI) is the current flagship program of the South Centre for promoting cooperation among developing countries on international tax matters. The program aims at the important need to increase collaboration among developing countries on international tax issues and reform processes.

With a focus on network building, the SCTI is centred on the convening of the Annual Forum on Developing Country Tax Policies and Cooperation for Agenda 2030. The Annual Forum aims at bringing together developing country officials working in tax policy and administration to promote and support intensified, better coordinated, and more institutionalized approaches to South-South cooperation in tax matters; so as to enable developing countries to become full participants for substantive norm-setting in international taxation.

The SCTI builds on the reality that developing countries, such as India, Brazil, China, Ecuador, Kenya among others have been undertaking their own innovations in tax policy, in line with their capabilities and their need to obtain more tax revenues from economic activities that take place in their own jurisdictions. Therefore, a major effort to build a working network among developing country officials would allow for the sharing of experiences and practical solutions for taxation in developing countries, as well as for strengthening their participation, and providing a coordinated approach in international fora.

With a focus on network building, the SCTI is also meant to improve research capacity on taxation issues in the developing

country context, strengthen and coordinate common negotiation positions in international fora, and establish mechanisms among developing country tax authorities to arrive at agreed norms and actions at the regional and global level to achieve a more effective and just system of taxation.

The SCTI undertakes a wide range of activities for increasing international tax cooperation among developing countries, with its main objectives being oriented towards guaranteeing that the ongoing global reform process goes in “the right direction”, by:

- Improving research and analysis by developing country authorities and academics, and upgrading local capacity to respond to their own needs towards the design of effective tax policies for their own countries, drawing on lessons and experiences from other developing country experiences;
- Strengthening developing countries’ engagement and coordination in international tax cooperation forums and activities such as in the OECD-G20 processes, the UN tax cooperation work, and regional cooperation activities; and
- Providing international tax cooperation spaces among developing country authorities to discuss and facilitate the discussion on the design of agreed norms and mutual action at the regional and global levels.

Within this broader context, the objective of SCTI’s publication program is to create a space in the international professional and policy community for tax officials, academics and civil society stakeholders from the Global South to put forth their views, experiences and perspectives which are sorely missing from the prevailing global narrative on international taxation.

The program was sparked off by a two and a half day Author’s Workshop, held on 28 - 30 August 2017 at the South Centre in Geneva, at which twelve authors from different developing countries, including tax administrators and civil society representatives, came together and presented their ideas and outlines, which were discussed and subsequently developed into the chapters in this publication.



This publication, which developed as an outcome of the Workshop, is a collection of policy papers focused on international tax cooperation and the developing countries' experiences on the implementation of tax policies and to introduce innovations in international tax standards. As will be evident in all the chapters, responses to the realities confronting tax administrators and negotiators in developing countries are driven by the need of these countries to protect their taxing rights against base-eroding strategies implemented by MNEs, through which they are able to relocate the related transactions and shift profits for reducing their tax liabilities. This leads to an increased burden being borne by the domestic enterprises, pushing public sectors in developing countries to achieve a certain level of revenue to fund their operations, particularly in the context of increased demands created by Agenda 2030.

More significant is the fact that many of the residence-based rules favoured by developed country authorities, as embodied in the OECD double taxation model treaty for example, facilitate the shifting of profits and the dissipation of the tax base of host countries. These rules enable related companies to engineer transactions and their prices to favor jurisdictions with lower tax rates, fuelling both a race to the bottom on statutory tax rates and revenue losses from tax avoidance in developing countries which have as a rule higher tax rates. The chapters in this volume analyze various strategies of developing countries to strengthen national capacities to minimize these losses. Each chapter seeks to present a specific tax approach, elaborates on the purposes of that approach, and analyzes the prospective or actual impact of the policy against its objectives.

This publication of the South Centre Tax Initiative is a key element of the knowledge building and networking platform where tax authorities, practitioners and academics from different tax jurisdictions share their experiences and perspectives. The present volume is divided in the following nine chapters:

In the second chapter, **Prof. Marcos Valadão** examines the 15 action points of the G20/OECD BEPS project and their significance

for developing countries in the context of an interdependent and unequal world. The first part of the chapter focuses on the recent international initiatives for curbing tax base erosion and profit shifting strategies. Then, the author provides a description of the Brazilian approach to the BEPS Project and its action points, and concludes by exploring the relevance of regional cooperation in contrast with international organizations to address the issue.

For the third chapter, **Dr. Vinay Singh** focuses on recent changes in Article 7 of the OECD Model Convention update in 2010. Before the revision, profit attribution to permanent establishment and transfer pricing were treated under different articles, and Article 7 of the OECD Model allowed sales to be taken into account both in the direct accounting and the indirect apportionment method. The revised Article 7 approximated profit attribution to transfer pricing but omitted the option for the apportionment thereby undermining sales and contributions made by market jurisdiction to business profit. Thus, when negotiating tax treaties, developing countries should fully understand the implications of the revised Article 7 in their tax treaties in order to make informed choices regarding transfer pricing and profit attribution to permanent establishments, including the possibility of using the apportionment method that takes sales into account.

**Verónica Grondona** addresses transfer pricing issues in the extractive industry in the fourth chapter. For many developing countries, the extractive industry is a significant part of their economies and the profit and the attribution of profits rules may highly depend on the valuation of the commodity exports. A significant number of developing countries are adopting the “Sixth Method”, following the Argentine experience that establishes a clear and easily administered benchmark, avoiding subjective judgement and discretion by tax authorities. However, data shows that commodity mis-invoicing is still a current practice among multinationals in spite of the adoption of the “Sixth Method” based on Argentina’s experience.

**Thulani Shongwe’s** contribution in the fifth chapter looks at some of the key aspects of the modern transfer pricing legislation

and illustrates how different drafting of regulations can assist in additional revenue collection as well as increased compliance. It further provides practical examples from real cases to show where poor legislation has given rise to tax planning and to profit shifting. Lastly, the chapter offers practical solutions to some of the transactions illustrated through the African Tax Administration Forum (ATAF) Suggested Approach to Drafting Transfer Pricing Legislation.

In the sixth chapter, **Jahanzeb Akhtar** explores the implementation of the Exchange of Information standard developed by the OECD. Although the standard is a critical tool for addressing the information asymmetries between taxpayers and governments, the Exchange of Information model was designed by the OECD without the participation of developing countries. The chapter explores India's experience with the implementation of the standard for Exchange of Information for tax purposes and discusses the lessons drawn from that to inform tax authorities from other developing countries which are grappling with BEPS issues.

For the seventh chapter, **Hon. Irene Ovonji-Odida** and **Algresia Akwi-Ogojo** analyze the issue of illicit financial flows (IFF). The High Level Panel on Illicit Financial Flows, a timely initiative led by H.E. Thabo Mbeki, brought the issue into the global spotlight, and it has gained much momentum since with the release of data like the Panama Papers. The chapter elaborates on the conceptual underpinnings of IFFs, its sources and the development costs they incur. Building on the report of the High Level Panel, the chapter provides recommendations for stakeholders to help stem IFFs from developing countries.

**Alexandre Akio Lage Martins** presents the experience of Brazil on tax haven lists from 1995 to 2015 in the eight chapter. The chapter describes the experience in compiling the national list of tax havens, the roadmap followed for its implementation, and the impact on foreign investment flows. The author concludes by sharing the lessons learnt from the Brazilian experience, which could help other developing countries facing the same issues.

In the ninth chapter, **Dr. Lorena Freire Guerrero** provides a vivid description of how Ecuador improved tax collection by implementing domestic anti-fraud regulations and international proposed measures related to transfer pricing and tax havens. These measures have helped to increase the tax base and tax collection with a positive impact on the redistribution of wealth and equality in Ecuador by means of allowing more social investment in healthcare, education, road infrastructure, for example.

In the final chapter, **Dr. Mariama Williams** provides a brief survey of the policy relevant literature on gender and taxation issues and considers how these issues are relevant to and are being taken on board in developing countries' tax (reform) policies as well as with regard to regional and international tax cooperation. In addition, the author explores the relation between tax justice and gender justice from the stand point of illicit financial flows/tax avoidance and evasion and highlights issues in gender and tax cooperation.

The international tax system is in the preliminary stages of a much needed, thoroughgoing transformation. This global effort will not succeed without the active and effective participation of developing country governments and experts. We believe that publications such as this one, the first of others which we plan to publish, will establish a robust voice for developing countries in this collective effort.

# CHAPTER 2

## DEVELOPING COUNTRIES

### AND THE CONTEMPORARY INTERNATIONAL TAX SYSTEM: BEPS AND OTHER ISSUES<sup>1</sup>

Marcos Aurélio Pereira Valadão

#### I. INTRODUCTION

This chapter addresses international tax cooperation in an interdependent world, the issues that are present in the Base Erosion and Profit Shifting (BEPS) Project, and those that, in my perspective, are the most important for developing countries.<sup>2</sup> Following that, the chapter considers the Brazilian approach to those issues. It will also verify the issue of regional cooperation *vis-à-vis* international organizations.

#### II. THE CONTEMPORARY INTERNATIONAL TAX SYSTEM<sup>3</sup>

It is important to look at the structure of the contemporary international tax system from the perspective of developing countries, through a critical approach. Because of sovereignty, each country has its own tax system, and most of them are designed considering the three classical bases of taxation: income, consumption, and property.

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 7 (February 2019). A previous modified version of this chapter was first published in the Brazilian Journal: *Revista de Finanças Públicas, Tributação e Desenvolvimento (Journal of Public Finance, Taxation and Development)*, V. 6, n.7 (July-December 2018), pp. 122-135.

<sup>2</sup> When mentioning developing countries, the text also refers, in general, to less and least developed countries.

<sup>3</sup> This section of the chapter is based on the article: Marcos Aurelio Pereira Valadao, “O Sistema Tributário Internacional Contemporâneo sob a Perspectiva dos Países em Desenvolvimento: Análise Crítica,” *Nomos (Law Review)*, vol. 37, no. 1 (2017), pp. 147-198. Available from [www.periodicos.ufc.br/nomos/article/view/20101/30830](http://www.periodicos.ufc.br/nomos/article/view/20101/30830) (text in Portuguese, English title: The Contemporary International Tax System from the Perspective of Developing Countries: A Critical Analysis).

As the extreme process of globalization in the last decades of the 20<sup>th</sup> century expanded towards the 21<sup>st</sup> century, the development of the international market, and the enormous ease and increase of international financial transactions led to an unprecedented interconnection of tax systems. In this context, along with the historical approach of the model conventions on double taxation, some international organizations, such as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN), stepped up by installing working groups on tax matters. But such organizations are not always concerned about the issues of developing countries. The OECD, for instance, is controlled by rich and developed countries and comes naturally with the intent to preserve their tax bases, according to their interests. Which is quite natural, that is to say, no one can expect it to be different.

The design of the contemporary international tax system facilitates wealth concentration, as has been extensively discussed by economists and non-governmental organizations (NGOs). This aspect has, as its consequence, the increase in global inequality. Such massive wealth concentration triggers other crucial issues as political and social problems, compromising the international equilibrium and it is now putting at risk even the most stable democracies, as has been pointed out by Joseph Stiglitz.<sup>4</sup> Moreover, organized civil society, through several non-governmental organizations, has been trying to help to address these issues on international taxation. For instance, the Tax Justice Network, OXFAM, and Christian Aid, which aim to promote a fairer tax system, focus their efforts on the issues of developing countries.

Another problem is the “big players”, which are huge transnational companies and high net-worth individuals, who take advantage, many times aggressively, of the loopholes of tax systems and the benefits offered by many countries around the globe to attract investments to their jurisdictions. This results in the reduction of companies’ tax burden while eroding the countries’ tax bases. This scenario called the attention of all countries. The OECD thus started initiatives such as the harmful tax competition report, the tax transparency forum, and more

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<sup>4</sup> Joseph Stiglitz, *The Price of Inequality: How Today’s Divided Society Endangers Our Future* (New York, W. W. Norton & Company, 2013), pp. 148-182.

recently, jointly with the Group of Twenty (G20), the Base Erosion and Profit Shifting (BEPS) project.

All this considered, in the context of the contemporary international tax system, there are some problems affecting developing countries more severely, such as international harmful tax competition, tax havens, transfer pricing, tax deferral by controlled foreign corporations (CFCs), treaty shopping, thin capitalization, digital transactions (digital economy), and capital gains in indirect participation transfer.

Looking towards building a better society, governments need enough revenue to implement public and social programs, to improve their Human Development Index and wealth redistribution. Thus, it is important to analyse these international tax-related problems in the perspective of developing countries, which have their specific needs, and specific problems.

The characteristics of developing countries, and not just those of developed countries, must be considered when creating and implementing international instruments. To promote the desired economic and social development, countries need to design and maintain efficient tax systems. In line with that, one aspect that must be highly considered is foreign investment. In this case, tax benefits have a major role. It is important to highlight that attention must be directed to the destination of this revenue ( for example, investments should be directed to activities that may result in more efficient and measurable results, such as infrastructure and innovation). This is a crucial aspect that is also related to an important problem of the contemporary international tax system, that is harmful competition and the so-called “race to the bottom,” which must be properly addressed.

The relation between the tax system and development has been on the agenda for a long time. However, there are some countries which have an insufficient tax base with very few alternatives and therefore must choose wisely on how to finance their development in a sustainable way. Furthermore, when analysing the tax systems of developing countries, it is important to look at the tax system and the fiscal benefits in general; how they impact the economic and social development and how they interact with the contemporary international tax system.

The interaction between countries' tax systems and the contemporary international tax system results in positive and negative effects, depending on the way each system is designed. It is essential to a country's tax system to be organized in a way that allows it to be inserted in the international market and interact positively with the contemporary international tax system. But having it clear that the mainstream of the contemporary international tax system is controlled by interests that are not necessarily in line with developing countries' needs, one must also consider other factors, such as institutional stability, and predictability.

On the downside, it is notable that not all developing countries have administrative structure or technical expertise to deal with complex subjects involving international taxation matters, resulting in tax base erosion and profit shifting. And because of their poorly designed tax systems (i.e. deficient tax laws, lack of staff and expertise to deal with complex matters), developing countries might be more exposed to the issues that surround the contemporary international tax system, sometimes described in the literature as "tax termites". In this context, other problems arise, such as the inefficient monitoring of illicit money flows and transnational crimes. Again, it is not only a question of the normative system, meaning the tax law system itself.

### **III. BEPS AND DEVELOPING COUNTRIES, AND SOME ASPECTS OF BRAZILIAN PRACTICES<sup>5</sup>**

The importance of the BEPS project, which in fact should be called "anti-BEPS" project, is so noted that some people are splitting the history of modern international taxation in a pre-BEPS era and the post-BEPS era.

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<sup>5</sup> This section of the chapter is based on the book chapter: Marcos Aurelio Pereira Valadao, "O Brasil e a iniciativa BEPS", in *Desafios y Primeros Avances del Proyecto BEPS en Latinoamérica*, 1<sup>st</sup> ed., vol. 1, Gemma Patón García, ed. (Lima, Peru, Thomson Reuters, 2016), pp. 93-118 (text in Portuguese, title in English: Brazil and the BEPS Initiative), and on the paper: Marcos Aurelio Pereira Valadao, "The Relationship Between Transfer Pricing Law in Brazil and BEPS Actions 8, 9, 10 and 13", *Bulletin for International Taxation*, vol. 70 (2016), pp. 36-59.



From the beginning of this century, one very important issue which has been raised in importance and became a sort of consensus is that of tax transparency; in the sense of access to information on taxpayers' operations and the beneficial owner of such operations. In the last century there was a perception regarding harmful tax competition related to "harmful tax practices" (a non-precise concept) being linked to tax transparency; also in the sense of access to information.

However, for several factors, such as global exposure to terrorism, human trafficking, drug trafficking and similar illegal actions, the issue of tax transparency became very strong. As a consequence the "Global Forum on Tax Transparency" became the "Global Forum on Transparency and Exchange of Information for Tax Purposes" - an important multilateral international agency dealing with these issues, which became more and more important, especially after the world financial crises of 2007-2008. All governments needed to know the beneficial owners of the deposits and other financial assets. The Global Forum, despite the fact that it was born under the OECD structure, was transformed into an "equal footing" forum, with strong participation of developing countries, including low-tax small jurisdictions. One can say that the need for information exchange and tax transparency became a consensus, maybe the only one in the contemporary international tax system. Indeed, in the BEPS Project, Action 13 (information exchange regarding transfer pricing) is part of the so called minimum standard of BEPS.

The BEPS project comprises 15 Actions, which are briefly addressed below, along with how they relate to the Brazilian experience when appropriate, and other global aspects.

#### Action 1 - Addressing the Tax Challenges of the Digital Economy.

This is an issue that has been postponed since the 1990s. The issues that surround the digital economy are important to all countries, but the outcome of the BEPS report is disappointing. The rich countries, where the high-tech companies are located, do not want to touch this issue in depth. Now we have the cryptocurrencies issue becoming

more and more important. The problem with digital economy goes a little beyond the mere allocation of taxing rights, because we are starting to face situations such as wealth in the cloud, that is to say wealth with no relation to any country. But we must keep in mind that at the end of the ownership chain there will always be a human being, who is a citizen of a given country, and that unilateral solutions will always be full of loopholes. When the transaction involves tangible property, the issues can be addressed through traditional tax tools. Now, however, the valuable transactions increasingly involve more and more intangibles. The only solution to tackle the hard issues of the digital economy is a multilateral convention, and maybe a tax on international transactions, under an international tax authority, which should be shared among the countries. This a very complex issue, and developing countries must be involved in the discussions of this issue to not be left behind in the final solution (or solutions).

#### Action 2 - Neutralizing the Effects of Hybrid Mismatch Arrangements.

This type of arrangements, or tax planning, results in double non-taxation or double tax deductions. The problem is magnified when country legislation allows for transparent (“pass-through”) entities, because it eases tax treaty abuse. In this case the general guidance of the Report on Action 2 and the measures proposed in the multilateral convention (Action 15) are a reasonable solution for the case of treaty abuse.

While not suggesting that the Multilateral Convention as a whole is a good option, each country must look at its own tax system and how this issue affects it, in order to propose changes in legislation. Brazil does not face considerable problems with this aspect, mainly because Brazilian legislation does not allow transparent entities.

#### Action 3 - Designing of Effective Controlled Foreign Company Rules.

While this is a very well-known issue, if a country does not have resident multinational companies doing business abroad or adopts territorial taxation, it is not that important. However, most countries have companies operating abroad through subsidiaries, associated

enterprises or branches, which trigger the issues. While Brazilian CFC legislation used to be very strict (for example, there was no distinction between active and passive income), it was changed in 2014. Before that, any profit made abroad would be taxed in Brazil. The legal definition of controlled and associated enterprise was very well delineated (and still is). The changes in 2014 made it more flexible as the Brazilian Supreme Court decided that the law could not tax the profits of associated enterprises attributable to a Brazilian associated company (unless the foreign company is resident in a tax haven or is a controlling company). Brazilian legislation goes beyond BEPS recommendations, and is being criticized for its negative impact on the competitive advantage of Brazilian companies operating abroad.

#### Action 4 - Limiting Base Erosion via Interest Deductions and Other Financial Payments.

This is a very important aspect for developing countries that are subject to foreign capital allocation and the interest payment, instead of dividends after tax, which may drain the tax base. The report of this Action gives information on how to address the problem limiting the deductions. Brazil's approach to this problem is also very tough. Interests are subject to 15% withholding taxation which is raised to 25% on any interest payments to residents in tax havens; interests are subject to transfer pricing rules based on an interest rate related to the money market (a sort of sixth method for loans and financial instruments). In addition, any payment of interest to a resident in a tax haven (or entity under a preferential tax regime) will also be subject to transfer pricing rules and application of thin capitalization rules, which are stricter if the lender is located in a tax haven. Deduction of interest payments to tax havens are submitted to strict scrutiny to allow deduction. The Brazilian approach is quite interesting and efficient, and restrictive of profit shifting.

#### Action 5 - Countering Harmful Tax Practices More Effectively, Considering Transparency and Substance.

This issue is controversial as the recommendations to tackle the problem (which may lead to the so-called "race to bottom") are

controversial in some respects. One practice is to decrease the tax rate in general; another is to promote actions to attract capital by implementing special tax regimes. Many developed countries use this strategy. The problem is when the beneficial regime is used only to shift profit, with no economic improvement. The Brazilian tax system adopted a list of tax havens and preferential tax regimes of other jurisdictions that triggers special tax treatment, such as higher withholding rates and transfer pricing rules.

#### Action 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances.

This is an issue that affects more those countries with an extensive net of treaties. However, most countries, even developing countries, have at least a bunch of tax treaties. The report and suggestions from Action 6 are fine in terms of proposals (especially the principal purposes test (PPT) and limitation-on-benefits clauses), because they effectively make it more difficult for taxpayers to take advantage of treaty shopping schemes. However, the use of a PPT clause may pose some difficulties in practice because of its subjectivity; the same that one finds when applying General Anti Abuse Rules. The aim of double taxation avoidance agreements is to grant relief from double taxation but not to induce double non-taxation. This issue is important, but it does not represent a challenge for developing countries in particular, except for the subjectivity of PPT.

#### Action 7 - Preventing the Artificial Avoidance of Permanent Establishment Status.

This is also an important issue because the artificial avoidance of permanent establishment (PE) status without appropriate taxation at source will result in profit shifting. When it comes to tax treaties, the issue is still important, and the proposals of Action 7 may improve tax base protection. However, when taxation at source is strong and extends to all type of payments this issue tends to be less important. In Brazil this issue is not a source of dispute. However, e-commerce and the digital economy will bring new issues regarding the concept of PEs.

Actions 8, 9, and 10 - Transfer Pricing (the three actions considered together as related to Intangibles, Risks, Capital High-Risk Transactions); and Action 13 - Transfer Pricing Documentation and Country-by-Country Reporting.

These Actions relate to the most important issue of the contemporary international tax system. Transfer pricing (TP) is very important to developing countries because it is the easy way to transfer profits from one jurisdiction to another, although it is subject to complex discussions.

The rules are complex, with the prevailing methods coming from the OECD, the so-called Guidelines, and more recently the UN Transfer Pricing Manual for developing countries, which is an initiative aimed to help developing countries to apply such methodologies. However, the UN Manual also brings some different country practices, especially Brazilian methodology regarding the use of fixed margins, which is discussed here. The BEPS project also resulted in an update of the OECD Guidelines.

The value formation issue involves the world of transfer pricing and there are many ongoing discussions regarding aspects which are more related to developing countries, such as saving location and market value. Traditional tools of transfer pricing need to be updated to address intangibles and other transactions (such as low value intra-group services and capital cost allowance), and the BEPS action dealt with that under the OECD approach (arm's length principle). A different result was the acceptance of the sixth method which was not developed under the OECD approach, but by non-OECD countries, such as Argentina and Brazil.

Action 13 is very important because information is necessary to look at the transactions as a whole and identify the related parties, as well as where the profits arise in and where they go to. It is also under the consensus of the need for information exchange.

As for the Brazilian approach to transfer pricing, one can say that the BEPS would not affect the Brazilian approach too much. Some aspects of the Brazilian approach on transfer pricing are as follows:

- TP Regulations in Brazil apply to juridical persons (companies) and individuals when performing international transactions. Transactions with royalties and the remuneration for the transfer of technological know-how are not subject to TP Regulations in imports – this is very important because Brazil does not face the challenge of intangibles. However these operations are subject to limited deduction. Transactions that are subject to TP adjustments include: (1) imports and exports of goods, services, and rights with related parties; (2) payments or credits for interest paid or received on international loans. The definition of related parties is very broad. Brazilian TP regulations also apply to operations performed by individuals and legal entities in Brazil with any individual or legal entity, residing or domiciled in a low tax jurisdiction, and operations performed with persons entitled to privileged tax regimes in a foreign jurisdiction, regardless of whether the latter is a related part. In addition, this rule also applies to non-transparent jurisdictions. Brazilian legislation seeks to adopt the arm's length principle. The methods are traditional transaction methods - comparable uncontrolled price method (CUP), cost plus method (CPM) and resale price method (RSP) (with different margins for different economic sectors). The transactional profit methods (the profit split method and the transactional net margin method (TNMM), both present in the OECD TP Guidelines) or formulary apportionment are not allowed. Regarding the CUP, goods that are considered commodities are subject to the sixth method based in market prices as a comparable. About the cost plus and resale price methods, instead of making use of comparable transactions, the law established fixed margins for gross profits and markups. This aspect is very important because it means simplification and predictability.
- It is also important to point out that those margins may be modified by an Act of the Minister of Finance, *ex officio*, or under a request presented by the taxpayer or taxpayer association.
- On the other hand, taxpayers may use the method that better fits (or works) for the operations (best method approach does

not apply), except for operations with commodities where it is mandatory to use the sixth method. There are special rules for loans, for which basic rates are determined by the London Inter-bank Offered Rate (LIBOR) in US dollars and Brazilian bonds have fixed rate depending on the situation.

- Considering the simplicity of the Brazilian methodology, and by weighing all aspects, the conclusion is that for developing countries the methodology adopted by Brazil is highly effective and efficient. Two aspects that demonstrate the efficiency of the methodology: the low cost it poses to tax administration and taxpayers, if other countries are considered; and the low number of tax disputes involving transfer pricing disputes, considering other tax issues.

#### Action 11: Measuring and Monitoring BEPS.

It is a procedural issue, as tools to take decisions. It is important to all countries in general. Everybody needs data. We are going to see if it is consistent or not.

#### Action 12: Mandatory Disclosure Rules.

It is an interesting approach which may be useful to all countries. However, its implementation may face difficulties related to the law system of each country and cultural aspects. In Brazil, a provisional measure (a sort of bill of law with application upon edition) regulating the mandatory disclosure procedure was rejected by the Congress.

#### Action 14: Making Dispute Resolution Mechanisms More Effective.

This action is an action under the perspective of the taxpayer. Of course, the taxpayer has the right to have the disputes timely resolved. However, this action brings an important aspect, that is the recommendation on arbitration. The problem of arbitration or mandatory arbitration is that the arbitrators will have the tax culture of developed countries (taxation at residence) and it will result in a bias in the arbitral decisions. Brazil has not adopted tax arbitration.

### Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.

This instrument brings some of the preceding discussions. However, the instrument itself is problematic. It is an innovation in terms of a multilateral treaty, but maybe the best way to implement some of the BEPS achievements is by means of renegotiating the double taxation avoidance agreements (DTAAs). It is because the way the Multilateral Instrument is applied may generate lots of doubts on what is in force in relation to each country and other issues; thus it will trigger interpretation disputes. Brazil has not signed it yet.

## IV. OTHER ASPECTS

Initiatives such as the Annual Forum on Developing Country Tax Policies and Cooperation and the South Centre Tax Initiative, under the leadership of the South Centre, are very important, because it brings the perception that countries, especially developing countries, have different needs, different cultural backgrounds, different tax regimes and tax laws. These differences reflect in the tax system and how it interacts with the contemporary international tax system. In other words, there is no one-size-fits-all solution. One thing is harmonization and implementation of some measures related to some consensual issues. Another very different thing is the uniformization of tax systems and legislation; and how they interact with the contemporary international tax system. Even the most powerful economy of the world, the United States of America, recently changed its tax system, not to make it closer to the “consensus”, but to perceive economic goals that are in line with their economic interests, which are not necessarily in line with other countries’ interests.

Developing countries thus must rely on other successful developing countries’ practices and be cautious when demanded to reform their tax system to be more aligned to what developed countries do.

Another important thing is the role of international organizations and associations. We have the UN Committee, OECD (Center for Tax Policy and Administration), regional tax organizations such



as the Inter-American Center of Tax Administrations (CIAT) and the African Tax Administration Forum (ATAF), and the NGOs; sometimes with the same focus on specific issues of developing countries but acting separately, which is a waste of scarce resources. The South Centre could work as a hub for such initiatives, or at least some of them which are more in line with the Centre's institutional targets.

On transfer pricing, developing countries must focus on simpler methodologies and consider adopting the "sixth method" (based on the prices of commodities in the international stock markets), which is also applied to commodity imports. In respect of controlled foreign corporations it is recommended that developing countries have an effective CFC rule, even when not having many multinational companies installed in their jurisdictions. Another important point is the negotiation of treaties for the avoidance of double taxation, which must be concluded with countries with investment potential and having specific and general anti-abuse clauses. Concerning thin capitalization, the adoption of rules based on the percentage of the debt related to net worth is more efficient. Besides, it is necessary to control the rate of interest paid through transfer pricing rules. About the digital economy's transactions of intangibles, the best possibility to diminish its negative impact would be a multilateral international agreement imposing taxation at the place of consumption. Regarding capital gains in indirect participation transfers (*capital gains* arising from *indirect transfers of participating* interests arising abroad but related to assets located in the country), it is important that developing countries' legislation addresses the taxation of these operations adequately. Transactions with tax havens must always be treated as being performed between related parties, and in this situation, withholding tax rates may be increased. Low-tax jurisdictions must receive specific treatment to avoid tax base erosion, observing the use of several different measures.

Finally, other important considerations: (i) taxation over consumption is regressive, resulting in wealth concentration, and is a problem that must be addressed; (ii) adopting a value-added tax (VAT) for taxing consumption is recommended; (iii) tax benefits

offered to multinational enterprises must be avoided if not extended to local companies; (iv) profit taxation of the extractive industry may be problematic, needing special attention; and (v) developing and developed countries must align their efforts to address the excessive global wealth concentration, which might result in an international tax over assets and internet financial transactions, and the establishment of an international tax authority.

## **V. FINAL REMARKS**

There is an urgent need for international coordination of tax policies, but close attention must be paid to the differences between developed and developing countries. The adoption of these recommendations could lead developing countries to a fairer relationship with the contemporary international tax system. Additionally, developing countries must focus their efforts on contemporary international tax system problems, having practicality and predictability as goals. This is important because any conflict between developing countries' normative tax system and the norms used by rich and developed countries is more likely to be resolved from the point of view of the taxpayer of the rich countries (countries from which the contemporary international tax system rules come from).

For these reasons and amongst others, initiatives such as the Annual Forum on Developing Country Tax Policies and Cooperation and the South Centre Tax Initiative under the leadership of the South Centre, are very important.

# CHAPTER 3

## INTERACTION OF TRANSFER PRICING & PROFIT ATTRIBUTION: CONCEPTUAL AND POLICY ISSUES FOR DEVELOPING COUNTRIES<sup>1</sup>

Vinay Kumar Singh

### I. INTRODUCTION

Last two decades have seen several significant developments in the area of profit attribution to permanent establishments (PE) and transfer pricing (TP), leading to two contradictory views. One view prefers analysis of functions, assets and risk (FAR) for TP as well as profit attribution, while the other does not. FAR based TP is still not applied universally, while FAR based attribution of profits is even more contentious. These developments pose significant challenges for developing countries and necessitate a detailed analysis of relevant issues.

### II. CONCEPTUAL ISSUES RELATED TO TAXING PROFITS

Since TP and profit attribution are intricately linked to the issue of taxing profits of foreign enterprises, it is worthwhile revisiting the conceptual basis underlying the international taxation regime.

#### *II.1 Factors that Contribute to Profits of Enterprises*

In the corporate tax regime, the tax base consists of profits, which are a function of the quantum of sales, price and cost of goods, as depicted by the following equation:

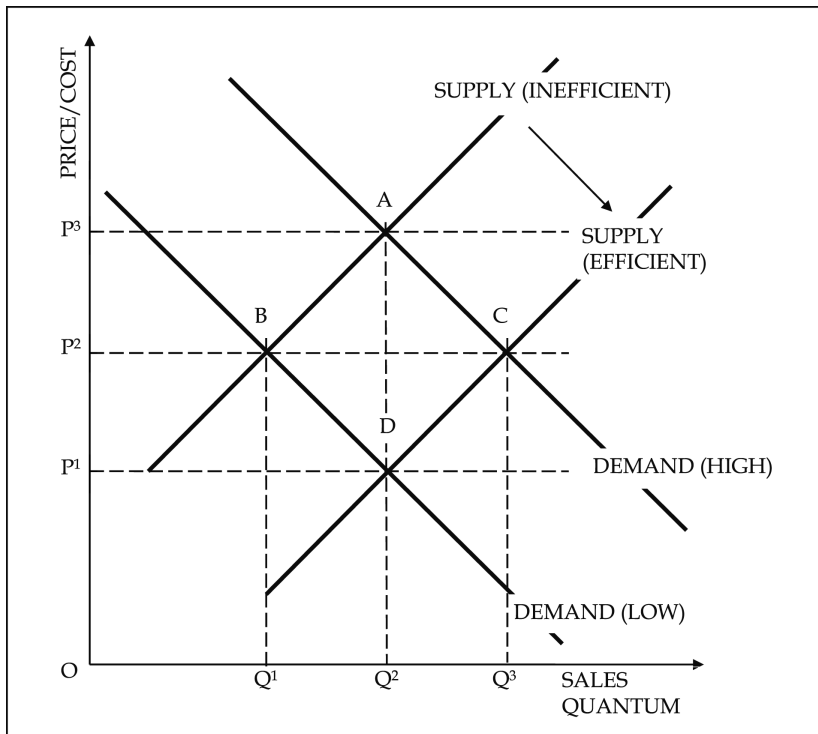
$$\text{Profits} = \text{Quantum of sales} \times [\text{Price} - \text{Cost}] = \text{Sales Receipts} \\ (\text{Turnover}) - \text{Cost}$$

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 3 (August 2018).

While cost is purely a function of supply, price and quantum of sales depend on the interaction of demand and supply, which apply independent of each other. Factors that affect supply include efficiencies of the enterprise, while demand depends primarily on the consumer's ability to pay, depending in turn on disposable income, which itself is a function of the state of the economy. In a given market, their respective contributions depend upon the elasticities of demand and supply. Both supply and demand are essential for giving rise to profits.

**Figure 1: Impact of Changes in Demand & Supply on Sales Revenue & Business Profits**



In a welfare maximizing, perfectly competitive market, improvement in supply efficiency in the presence of low demand shifts sales revenue

from  $OP^2BQ^1$  to  $OP^1DQ^2$ . In the presence of high demand, the change is from  $OP^3AQ^2$  to  $OP^2CQ^3$ . In either case, the resultant change in sales revenue and profit per unit sold is ambiguous, and profits rise only from higher quantum of sales. A shift from low to high demand in the presence of inefficient supply changes sales revenue from  $OP^2BQ^1$  to  $OP^3AQ^2$ . In the presence of efficient supply, the change is from  $OP^1DQ^2$  to  $OP^2CQ^3$ . In either case, sales revenue and business profits increase significantly from higher price as well as higher quantum of sales.

Interestingly, in a perfectly competitive market, reduction in costs of supply, resulting from improvement in efficiency of enterprises, is likely to result in higher sales but lower market price, with an ambiguous impact on sales revenue. Profits of enterprises rise in such cases primarily due to reduced costs. On the other hand, a higher demand, resulting from a higher ability to pay, is likely to result in more sales as well as higher market price, resulting in higher sales and increased profits for the enterprises, as apparent in Figure 1. In a monopoly market too, the sales revenue is governed primarily by the demand. Either way, the contribution of demand to sales revenue and profits cannot be ignored.

## ***II.2 Justification of Taxation in a Globalized Economy: The Benefit Principle***

Legitimacy of taxation of business profits is governed by the need for financing public goods, including protection of property rights and enforcement of contracts, essential prerequisites for functioning of markets. Public provisioning is also required for infrastructure, equity, addressing market failures and maintaining macro-economic stability, all of which facilitate markets and consumer demand, thereby contributing to profits derived by enterprises therein. This contribution of public resources to business profits constitutes primary justification for their taxation.<sup>2</sup>

Use of tax revenue for facilitating markets and economic growth sets into motion a “virtuous cycle” wherein tax supported economic

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<sup>2</sup> While other alternatives, such as debt, sales of assets and foreign aid also exist, taxes remain central to funding of public resources in most countries.

growth augments business profits, leading to a win-win situation. In the case of a multinational enterprise, the supply and demand may be spread over different tax jurisdictions. In such a case, the extent to which different tax jurisdictions contribute to the profits of that enterprise, by facilitating supply, facilitating demand or maintaining markets, provides a justification for them to tax such profits. The contributions made to the supply chain can be approximated by taking into account manpower, functions or assets, whereas the contributions by facilitating demand and maintaining markets are best approximated by sales revenue. When each jurisdiction taxes the profits to the extent of its contribution, while avoiding double taxation, the “virtuous” cycle of taxation can operate in the globalized economy.

These basic principles governing taxing rights can be traced as far back as Adam Smith’s First Canon of taxation, which provides the basis of both the benefit principle of taxation as well as the ability to pay principle, as quoted by Richard and Peggy Musgrave,<sup>3</sup> in these words: “*The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.*”<sup>4</sup> It has also been recognized as the primary basis of allocation of taxing rights between the country of residence and the country of source by T. S. Adams, who acknowledged that, “*A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment.... Business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market ...*”<sup>5</sup>

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<sup>3</sup> Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, 5<sup>th</sup> ed. (New Delhi, McGraw Hill Education, 2004), p. 219.

<sup>4</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, vol. 2, Edwin Cannan, ed. (London, Methuen & Co., 1904), p. 310. Available from <http://oll.libertyfund.org/titles/smith-an-inquiry-into-the-nature-and-causes-of-the-wealth-of-nations-cannan-ed-vol-2>.

<sup>5</sup> Thomas S. Adams, “The Taxation of Business”, *Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association*, vol. 11, November 13-16, 1917, p. 187. Available from <http://www.jstor.org/stable/23400384>.

The benefit principle was also resorted to by the four economists<sup>6</sup> invited by the Financial Committee of the League of Nations in 1921 to prepare a report<sup>7</sup> formulating the “general principles as the basis for an international convention to remove the evil consequences of double taxation.”<sup>8</sup> Their report stated, “*A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual’s whole faculty should be taxed, but that it should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each.*”<sup>9</sup> They recognized that the production of wealth focuses upon “*the community the economic life of which makes possible the yield.*”<sup>10</sup> Their report formed the basis of the 1927 Report of the Committee of Technical Experts on Double Taxation and Tax Evasion constituted by the League of Nations, which proposed the first comprehensive Draft Convention for the Prevention of Double Taxation.<sup>11</sup>

### ***II.3 Recognition of Sales as an Activity that Creates Value for the Enterprise***

These economists also recognized sales as the activity which creates value for the enterprise, by observing “The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage

<sup>6</sup> M. Bruins (Netherlands), M. Einaudi (Italy), E.R.A. Seligman (United States) and Josiah Stamp (United Kingdom).

<sup>7</sup> League of Nations Economic and Financial Commission: Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, Report on Double Taxation submitted to the Financial Committee — Economic and Financial Commission Report by the Experts on Double Taxation — Document E.F.S.73. F.19 (April 5th 1923) — Legislative History of United States Tax Conventions. Available from <http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;collection=;database=;query=;brand=default>.

<sup>8</sup> *ibid.*, p. 5.

<sup>9</sup> *ibid.*, p. 20.

<sup>10</sup> *ibid.*, p. 23.

<sup>11</sup> League of Nations: Committee of Technical Experts on Double Taxation and Tax Evasion, Double Taxation and Tax Evasion: Report — Document C. 216. M. 85 (London, April 12th, 1927) — Legislative History of United States Tax Conventions. Available from <http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-3.xml>.

until they are transported to the place where demand exists and until they are put where the consumer can use them.”<sup>12</sup> Their conclusion reflects that the value of any good being offered for sale is only as much as the price that the consumers would be willing to pay for it. Profits are derived only when consumers pay a price that is higher than the cost of supply, making apparent the contribution of demand to business profits.

T. S. Adams also recognized the right of the market jurisdiction to tax part of the profits on the basis of sales by observing, “*Income must to some extent be taxed where it is earned, at rates and by methods determined by the conditions under which it is earned - not by the conditions under which it is spent....Corporations and other business units derive benefits and compete with one another as units, in the jurisdictions in which they do business.*”<sup>13</sup>

Sales as the basis for taxation is also advocated by Richard and Peggy Musgrave, who write, “In regard to income and profits taxes, it is generally agreed that the country in which the income originates (also referred as the “country of source”) is entitled to tax that income...”.<sup>14</sup> They conclude that “The profits base of multinational corporations might be allocated among countries not by location of subsidiaries but in line with the national origin of profits earned by the business group as a whole. Such origin might be approximated by a formula including both location of value added and sales in its base.”<sup>15</sup> Different rationale for allocating taxing rights on the basis of sales have also been offered by Arthur Cockfield<sup>16</sup> and Richard L. Doernberg.<sup>17</sup>

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<sup>12</sup> *ibid.*, p. 23.

<sup>13</sup> Thomas S. Adams, “Fundamental Problems of Federal Income Taxation”, *The Quarterly Journal of Economics*, vol. 35, No. 4 (August 1921), pp. 542-543.

<sup>14</sup> See Musgrave and Musgrave, p. 571.

<sup>15</sup> *ibid.*, p. 573.

<sup>16</sup> Arthur J. Cockfield, “Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws”, *Connecticut Law Review*, Vol. 34, 2002, p. 396.

<sup>17</sup> Richard L. Doernberg, “Electronic Commerce and International Tax Sharing”, *Tax Notes International*, vol. 16 (1998), pp. 1013-1022.



Sales as the basis of taxing rights also finds support in Klaus Vogel's Commentary on the basis of efficiency<sup>18</sup> as well as equitable division<sup>19</sup> of taxation. It even goes to the extent of supporting the right of taxation of the market jurisdiction on the basis of sales, even in the absence of PE:

*“If an enterprise derives profits from say, supplying goods, such profits result not only from the goods having been produced in the enterprise's State of residence, but also from the opportunity offered in the recipient State for the sale of such goods. If the flows of goods between the two countries involved – or rather, more accurately, the profits resulting from those flows – are balanced, the question of what principle should be applied when distributing taxation is of relatively little significance, and in such a case adoption of the permanent establishment principle is recommendable because it is practicable. But if the flows are in imbalance, the recipient State is justified in requiring to be allowed to participate in the taxation of the proceeds of the sales of the goods – in the same way as it participates where interest and royalties are involved. The same applies to services rendered by the enterprise.”<sup>20</sup>*

#### **II.4 TP as a Tool to Prevent Artificial Shifting of Profits**

TP can be conceptually understood as the process of determining the arm's length price of intermediate goods in a cross-border, non-market transaction within a supply chain. Theoretically, it is based on the concept of the single market price. Where the market price of the transacted good is readily available, it can be easily identified from market price data (comparable uncontrolled price method). However, in cases where the market price in an uncontrolled transaction is not available, it needs to be estimated by using one of the indirect methods, relying upon data of other enterprises.

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<sup>18</sup> Klaus Vogel and others, *Klaus Vogel on Double Taxation Conventions*, 3<sup>rd</sup> ed. (New Delhi, Wolters Kluwer India, 2010), p. 14.

<sup>19</sup> *ibid.*, pp. 14-15.

<sup>20</sup> *ibid.*, p. 400. Vogel refers to the criticism by developing countries that the PE principle operates exclusively in favor of developed countries, and finds this criticism justified to some extent.

Avi-Yonah traces the origins of TP to the threat of “tax avoidance opportunities afforded by possessions corporations, which were ineligible to file consolidated returns with their domestic affiliates”,<sup>21</sup> which led to the introduction of US domestic law provisions in 1921 that authorized the Commissioner to consolidate accounts of affiliated corporations for the purpose of accurate distribution of their profits. These provisions evolved into Section 45 of the Internal Revenue Code in 1928, the text of which formed the content of Section 482 subsequently, dealing with transfer pricing regulations. Jens Wittendorf<sup>22</sup> provides an account of the tax dispute between the United States and France in the early 1930s related to over-invoicing of French subsidiaries of US companies, resulting in imposition of tax by French tax authorities on US companies that was objected to by the United States on the grounds of being extra-territorial and a breach of international principles. The dispute was finally resolved by the introduction of a provision based on Section 45 of the Internal Revenue Code as Article IV of the 1932 tax treaty between the United States and France.

This new development, which was the first of its kind at that time, prompted the introduction of Article 5 in the draft Convention for allocation of business income proposed in the League of Nations Fiscal Committee Report in 1933,<sup>23</sup> which subsequently formed Article 9 of the Model Tax Conventions. Given the separate entity status accorded to domestic subsidiaries of foreign corporations in the laws of most countries, these provisions provide an anti-abuse measure for

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<sup>21</sup> Reuven S. Avi-Yonah, “The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation”, Law & Economics Working Papers (Ann Arbor, Michigan, University of Michigan Law School, 2007), p. 3. Available from [http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1074&context=law\\_econ\\_archive](http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1074&context=law_econ_archive).

<sup>22</sup> Jens Wittendorf, *Transfer Pricing and the Arm’s Length Principle in International Tax Law* (The Netherlands, Kluwer Law International, 2010), pp. 75-76.

<sup>23</sup> League of Nations Fiscal Committee, Report to the Council on the Fourth Session of the Committee — Document C.399.M.204. 1933.II.A. (Geneva, June 15th to 26th, 1933) - Legislative History of United States Tax Conventions. Available from <http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-8.xml;chunk.id=0;toc.id=item-8;database=;collection=;brand=default>.

addressing artificial shifting of profits by mispricing the intermediate goods transacted between them.

### **III. TREATY PROVISIONS & CHANGES IN ARTICLE 7 IN 2010 BY THE OECD**

For optimizing the benefits of international trade and investment, countries often prefer to limit their sovereign right to tax by entering into tax treaties, based on model tax conventions (MTCs) developed by the Organisation for Economic Co-operation and Development (OECD) or the United Nations (UN) Committee of Experts.

#### ***III.1 TP Provisions in Tax Treaties***

Article 9 of the MTCs provides for TP adjustment of profits by determining the arm's length price of goods in cross-border transactions between associated enterprises. The primary objective of this provision is to address manipulation of price and not to attribute profits to a PE, which is purely the subject matter of Article 7. A corrective action under Article 9 is triggered only if a particular transaction between associated enterprises is not at arm's length price. The MTCs neither define arm's length price nor specify methods for determining it. The Contracting States may adopt methods advocated by OECD<sup>24</sup> or the UN Committee of Experts.<sup>25</sup>

#### ***III.2 Treaty Provisions for Attributing Profits to PE***

Article 7 of the MTCs provides the rules for attributing profits to PE. The UN Convention provides relatively greater taxation rights to the source country in the form of "force of attraction" rules and restrictions on deduction on expenses.<sup>26</sup> Apart from these differences, this article in the two conventions was somewhat similar till 2008, and sought to tax

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<sup>24</sup> OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (Paris, 2017). Available from <http://dx.doi.org/10.1787/tpg-2017-en>.

<sup>25</sup> UN Economic & Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York, UN Publishing, 2017). Available from <http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf>.

<sup>26</sup> The UN Convention allocates relatively greater taxing rights to the country of source than are provided in the OECD Convention.

only those profits of the PE that it would be expected to make if it was an independent and separate entity. This would normally be achieved by maintaining separate accounts for the permanent establishment (*separate accounting or direct method*).<sup>27</sup> However, in the absence of the same, both conventions provided for attribution of profits by way of apportionment as may be customary in that State (fractional apportionment or indirect method), in paragraph 4 of this article:

*“In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”*

### **III.3 OECDIUN Guidance on Methods for Apportionment for Attributing Profits**

The OECD Commentary on Article 7, prior to 2010, when Article 7 was revised, provided detailed guidance on the possible methods for applying apportionment, which is still relied upon and quoted in the existing commentary of the UN MTC. It stated:

*“The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. ... criteria commonly used can be grouped into three main categories, namely those which are based on the receipt of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part.”*<sup>28</sup>

Paragraph 24 in the Commentary on Article 7 in the 1963 OECD MTC containing this text was renumbered as 26 in 1977, 27 in 1992 and

<sup>27</sup> See Vogel, p. 442.

<sup>28</sup> OECD, Model Tax Convention on Income and on Capital 2010 (updated 2010), Full version (Paris, OECD Publishing), pp. C(7)-103-104.

54 in 2008, before being omitted in 2010. Till 2010, OECD recommended fractional apportionment of profits based on any one of the three criteria, i.e. receipts, expenses and working capital, for attributing profits to a PE. This paragraph is still relied upon and quoted in paragraph 19 of the Commentary on Article 7 of the UN Model MTC,<sup>29</sup> thereby indicating its acceptance by the UN Committee of Experts. Significantly, no country documented any observation, reservation or position in respect of this paragraph in the OECD MTC, 2008, before it was omitted, indicating the existence of a broad international consensus.

### ***III.4 Changes in Article 7 in the OECD MTC & Its Three Differing Versions***

In the 2010 update of the OECD MTC, Article 7 was amended by taking away the option of fractional apportionment and inserting the condition that profits should be attributed taking FAR into account. Prior to 2010, Article 7 had remained largely unchanged since the introduction of the OECD MTC in 1963. A large number of treaties retain either the earlier version of this article in the OECD MTC or the UN MTC version, both of which allow fractional apportionment, and do not impose FAR.

Thus, three standard versions of this article exist in tax treaties today, i.e. the pre-2010 version and the 2010 version of Article 7 in the OECD MTC and the Article 7 of the UN MTC. Since the Contracting States are governed by the provisions in their treaties, an inevitable result is the widening of differences in profit attribution to PE under different tax treaties. Profit attribution by apportionment can be resorted to, if the same is permissible under the treaty. However, where the treaty has adopted the revised Article 7 of the OECD MTC, which does not provide an option for apportionment, this option will not be available.

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<sup>29</sup> UN Economic & Social Affairs, United Nations Model Double Taxation Convention between Developed and Developing Countries (New York, UN Publishing, 2011), pp. 159-160.

### ***III.5 Implications of Changes in Article 7 by OECD***

The insertion of FAR in Article 7 in the 2010 update of the OECD MTC has major implications. It approximated the process of profit attribution with that of TP, thereby leading to an illusion that both of them are one and the same exercise, and can be undertaken in an integrated manner by a common FAR analysis. A more significant impact was to attribute profits solely on the basis of FAR, representing supply, which completely ignored the contributions made by the market jurisdiction to the profits of multinational enterprises (MNEs) by maintaining markets and facilitating demand. Lastly, it omitted the option of fractional apportionment, which was permissible in the earlier provision and thereby also took away the option of taking sales into account.

The changes in Article 7 suddenly overturned a long lasting broad international consensus that was based on sound principles of economics and provided fair division of taxing rights between jurisdictions contributing to profits of an enterprise. It significantly widened the wedge between the two MTCs, and increased tax uncertainty for MNEs, by subjecting them to different tax regimes under different treaties. It also aggravated the challenges faced by developing countries in implementing these provisions.

The most important implication, however, was the omission of sales, which prior to these changes, constituted the most important factor in profit attribution. In both other versions of Article 7, the “direct or accounting method” has sales as the beginning point, with profits computed after deducting expenses, while for “indirect or fractional apportionment method”, sales can be taken as a basis.

## **IV. LIMITATION OF FAR BASED PROFIT ATTRIBUTION**

The proposal for FAR based analysis for profit attribution suffers from significant conceptual and practical limitations. The foremost limitation is the omission of sales, which prevents the market jurisdiction to tax business profits derived from its territory on the basis of its contribution to them. Other limitations include conceptual problems in approximating TP with profit attribution, and the practical constraint arising from its complexities and costs, which can also create avenues for tax avoidance.

#### **IV.1 Incompatibility of Omitting Sales with Economic Theory and Country Practices**

As highlighted above, economic theory provides a strong basis for taking sales into account for taxing profits derived by MNEs from the economy. Literature also supports the option of attributing profits by apportionment based on sales. In a 1991 paper, Langbein suggested fractional formulary apportionment based on sales and working capital, each given equal weight.<sup>30</sup> He explains that while sales represent the demand or market side contribution, working capital represents the inputs or the supply side.<sup>31</sup> According to him, “... sales, if anything, are the more or most important factor in indicating the “relative contribution” of a component to an enterprises’ group profit.”<sup>32</sup>

Avi-Yonah and Clausing recommend formulary apportionment exclusively on the basis of sales, noting that, “In the case of a sales based definition, the measure of economic activity is sales, which focuses on the demand side of market value.”<sup>33</sup> Jinyan Li argues in favour of adopting a multi-factor apportionment formula based on sales, payroll and property.<sup>34</sup> The Tax Justice Network has also suggested apportionment based on a three-factor formula (property, payroll and sales) with a double weighted sales factor.<sup>35</sup>

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<sup>30</sup> Stanley I. Langbein, “A Modified Fractional Apportionment Proposal for Tax Transfer Pricing”, Working Paper 1990-17, September 30, 1991 (Ann Arbor, Michigan, Michigan Ross School of Business, 1991), p. 6. Available from <https://www.bus.umich.edu/otpr/papers/1990-17.PDF>.

<sup>31</sup> *ibid.*, p. 7.

<sup>32</sup> *ibid.*, p. 27.

<sup>33</sup> Reuven S. Avi-Yonah & Kimberly Clausing, “A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project”, Law & Economics Working Papers (Ann Arbor, Michigan, University of Michigan Law School, 2007), p. 13. Available from [http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1071&context=law\\_econ\\_archive](http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1071&context=law_econ_archive).

<sup>34</sup> Jinyan Li “Global Profit Split: An Evolutionary Approach to International Income Allocation”, *Canadian Tax Journal*, vol. 50, No. 3 (2002), pp. 823-883.

<sup>35</sup> Tax Justice Network, “TP in Developing Countries An Introduction”, 2013, para. 9.3. Available from [https://www.taxjustice.net/wp-content/uploads/2013/04/TP\\_in\\_developing\\_countries.pdf](https://www.taxjustice.net/wp-content/uploads/2013/04/TP_in_developing_countries.pdf).

Some countries have adopted practices for determining taxable profits by formulary apportionment that takes sales into account. These include the practice adopted by US States, based on a formula giving equal weight to sales, property and payroll. According to Nerudova, this practice dates back to the 1870s, and since the 1930s, almost all States of the Federation have been following formulary apportionment based on the “*Massachusetts formula*” that can be expressed as the following equation:

$$P_i = P_t \left( \frac{1}{3} \frac{C_i}{C_t} + \frac{1}{3} \frac{L_i}{L_t} + \frac{1}{3} \frac{S_i}{S_t} \right)$$

where  $P_i$  represents profits allocated to the state  $i$ ,  $P_t$  profits of the enterprise,  $C$  stands for property,  $L$  for labor and  $S$  for sales.<sup>36</sup> Validation of these tax rules by the Iowa Supreme Court and the US Supreme Court<sup>37</sup> have attracted considerable attention in literature and also resulted in greater allocation to sales, that goes up from one-third in the Massachusetts formula to as much as 90-100%.<sup>38</sup> Nerudova has also documented the practices in Canada, apportioning profits on the basis of sales and payroll.<sup>39</sup> Some other countries have also practiced apportionment, including Switzerland,<sup>40</sup> Germany,<sup>41</sup> Argentina<sup>42</sup> and India.<sup>43</sup>

<sup>36</sup> Danuše Nerudová, “Common Consolidated Corporate Tax Base: Sharing the Tax Base under Formulary Apportionment”, In *Proceedings of the 13th International Conference on Finance and Banking*, D. Stavárek and P. Vodová, eds. (Karviná, Czech Republic, Silesian University in Opava, 2012), p. 466. Available from [http://www.opf.slu.cz/kfi/icfb/proc2011/pdf/40\\_Nerudova.pdf](http://www.opf.slu.cz/kfi/icfb/proc2011/pdf/40_Nerudova.pdf).

<sup>37</sup> In *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), the Iowa Supreme Court held the validity of the State of Iowa to impose tax only on the basis of sales. The US Supreme Court confirmed the validity of the formulary apportionment method in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983) and *Barclays Bank PLC v. Franchise Tax Bd. of Cal.* 512 U.S. 298 (1994).

<sup>38</sup> See Nerudová, Table 3, p. 467.

<sup>39</sup> *ibid.*, p. 468.

<sup>40</sup> See Tax Justice Network, para. 10.3.

<sup>41</sup> *ibid.*, para. 10.4.

<sup>42</sup> Erika Dayle Siu *et al.*, *Unitary Taxation in Federal and Regional Integrated Markets* (Brighton, UK, International Centre for Tax and Development, 2014). Available from <https://assets.publishing.service.gov.uk/media/57a089ec40f0b652dd000486/ICTD-RR3.pdf>.

<sup>43</sup> Rule 10 of Income-tax Rules, 1962 permits use of apportionment in India.



A proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) in the European Union has been placed before the European Commission<sup>44</sup> in September 2016.<sup>45</sup> Article 28 of this proposal provides that the consolidated tax base shall be shared between group members in each tax year on the basis of following the *formula for apportionment ... giving equal weight to the factors of sales, labour and assets*:

$$\text{Share } A = \left( \frac{1}{3} \frac{\text{Sales}^A}{\text{Sales}^{\text{Group}}} + \frac{1}{3} \left( \frac{1}{2} \frac{\text{Payroll}^A}{\text{Payroll}^{\text{Group}}} + \frac{1}{2} \frac{\text{No.of Employees}^A}{\text{No.of Employees}^{\text{Group}}} \right) + \frac{1}{3} \frac{\text{Assets}^A}{\text{Assets}^{\text{Group}}} \right)$$

These details suggest that the post 2010 approach of OECD, which excludes sales as a factor for attributing profits to PE, is not in conformity with the economic principles and literature. Country practices, for instance, in the United States and the proposal for CCCTB in Europe also contradict the OECD approach that excludes sales and omits the option of apportionment for attributing profits to PE.

#### ***IV.2 Conceptual Problems in Applying TP Methods for Profit Attribution***

One of the limitations of TP methods based on comparable data to determine the arm's length price by arriving at a "standardized" profit margin is the lack of theoretical and conceptual support for such an exercise. While economic theory provides a basis for the arm's length price, in the form of a single price of an economic good in a competitive market, there is no such basis for the "arm's length profit". There is nothing in economic theory, whatsoever, to suggest that all enterprises in a competitive market are likely to have the same profit margin. On the contrary, economic theory explains the entry and exit of enterprises based on the difference between their respective efficiencies. Efficient enterprises are expected to dictate

<sup>44</sup> European Commission, Final Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) {SWD(2016) 341 final} {SWD(2016) 342 final} (Strasbourg, 25.10.2016). Available from [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/com\\_2016\\_685\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_685_en.pdf).

<sup>45</sup> The 2016 proposal is a modification of an earlier proposal for CCCTB that was initiated in 2011.

a more competitive price in the market which will make the less efficient enterprises non-competitive, leading to their exit.

There are other problems too. Schon pointed out, “*TP at marginal cost is generally not accepted by traditional TP tax rules.*”<sup>46</sup> This creates a stress with economic theory, which tells us that the decision of an enterprise to supply is governed by marginal costs.<sup>47</sup> Though profit attribution rules create a legal fiction by deeming the PE as a separate and independent enterprise, the actual decision making by an MNE is still based on the objective of maximizing its profits as a single unit, and is not a sum of decisions taken by its various units located in different tax jurisdictions to maximize their respective profits. It is this limitation of the legal fiction which necessitates the option of attributing profits by apportionment as provided in other versions of Article 7.

Another significant question mark on the accuracy of the TP approach for attributing profits is its inability to take into account the synergy rents or the additional profits that are derived by the MNE as a whole from the synergies created by carrying out different functions in different jurisdictions, in some instances, by utilizing the “comparative advantage” of different economies.<sup>48</sup> Since an enterprise is a single economic unit and takes its business decisions with an objective of maximizing its overall profits, rather than maximizing the profits of its different units, determination of how the synergy rents derived by running a comprehensive business across several tax jurisdictions are to be taxed by each of those jurisdictions cannot be ignored. Schon notes, “*From a tax point of view, these rents should not only be allocated to*

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<sup>46</sup> Wolfgang Schon, “Transfer Pricing - Business Incentives, International Taxation and Corporate Law”, Working Paper 2011-05, January 2011 (Munich, Max Planck Institute for Tax Law and Public Finance, 2011), p. 8. Available from <http://www.tax.mpg.de/RePEc/mpi/wpaper/Tax-MPG-RPS-2011-05.pdf>.

<sup>47</sup> Average cost includes sunk cost, which could be a factor in investing decisions.

<sup>48</sup> For instance, an MNE may decide to locate its manufacturing activities in an economy which is recognized for its efficiency in manufacturing, locate its service units in another economy efficient in services or having skilled labor available at lower wages and locate its research units in a third economy that is recognized for its innovation, while selling its products in different economies around the world.

the country where the “winning” business unit is located. These rents are due to the fact that the “losing” business unit provides a specific business opportunity to the other divisions of the firm. In other words: the “winning” business unit should be taxed not only in its location country but also in the jurisdiction where the other unit resides.”<sup>49</sup> He further points out, “Transfer prices should not be the final measuring rod for allocation of taxing rights between countries. They are meant to allocate profits between business units but not to define the framework of territorial source taxation. Therefore, synergy rents drawn by members of a corporate group should be allocated to the country where the synergy is located (e.g. from the use of specific investment in a country) not to the country where the corporation receiving the rent resides.”<sup>50</sup> The same issue has been analyzed by Wittendorff from the perspective of “Economics of integration”, which is characterized as “benefits that are not available to market participants in uncontrolled transactions”<sup>51</sup> to argue that they should be distributed among the participating units and not allocated solely to the head office.

#### **IV.3 Practical Constraints: Complexities, High Costs, Tax Disputes & Tax Avoidance**

FAR based TP has also attracted criticism due to its complexities and high costs of compliance and administration. Rosen cited anecdotal evidence of an enterprise which was required to include in its return, “computations for subsidiaries located in about 100 countries, exceeded 30,000 pages, and required the work of more than 200 tax professionals both in the United States and abroad (Herman, 1999).”<sup>52</sup> According to Avi-Yonah and Clausing, “the arm’s length standard has become administratively unworkable in its complexity. As a result, the arm’s length standard rarely provides useful guidance regarding economic value.”<sup>53</sup> They also refer to similar criticism by other experts.<sup>54</sup>

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<sup>49</sup> See Schon, pp. 8-9.

<sup>50</sup> *ibid.*, p. 15.

<sup>51</sup> Jens Wittendorff, “The Arm’s-Length Principle and Fair Value: Identical Twins or Just Close Relatives?”, *Tax Notes International*, April 18, 2011, pp. 223-249. Available from <http://corit-academic.org/wp-content/uploads/2011/12/62TI0223-4.pdf>.

<sup>52</sup> Harvey S. Rosen, *Public Finance*, 6th ed. (New York, McGraw Hill, 2004), p. 415.

<sup>53</sup> See Avi-Yonah and Clausing.

<sup>54</sup> *ibid.*, p. 9.

The complexities of FAR based TP and its inherent inability to objectively allocate profits among related parties is one of its most significant limitations from the perspective of developing countries, since it can create potential avenues for subjective application by taxpayers and tax authorities according to their respective objectives of tax minimization and tax maximization, leading to frequent disputes and tax litigation.

There has also been a criticism that TP creates avenues for tax avoidance. According to Avi-Yonah and Clausing, it “creates an artificial tax incentive to locate profits in low-tax countries, both by locating real economic activities in such countries and by shifting profits toward more lightly taxed locations.”<sup>55</sup> The explanation for this unintended and ironical outcome may lie in the limitations of applying TP, essentially an anti-abuse measure, as a universal method for determining taxable profits. Unlike an anti-abuse measure, a universal mechanism for determining taxable profits must be objective, free of undue complexities, and impose limited costs of compliance and administration, to be effective.

These concerns may have played a role in the proposal for CCCTB. The paper issued by the European Commission providing its justification states “...*business models of multinational companies have become more complex, intra-group transactions have multiplied and multinationals’ integrated value chains make it difficult to determine where profits are created. Governments struggle to determine within the current set of international tax rules which country should tax a multinational’s income. Smaller businesses are put at a competitive disadvantage and citizens perceive tax systems as unfair since some corporate taxpayers might be able to avoid taxation by exploiting tax planning strategies.*”<sup>56</sup> It also documents the expected outcomes of

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<sup>55</sup> *ibid.*, pp. 8-9.

<sup>56</sup> European Commission, Commission Staff Working Document, Impact Assessment, Accompanying the document, Proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CCCTB) {COM(2016) 683 final} {SWD(2016) 342 final} (Strasbourg, 25.10.2016). Available from [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/swd\\_2016\\_341\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/swd_2016_341_en.pdf).

this measure as “making EU tax law simpler and reducing regulatory costs, it is expected to contribute to a clear, stable and predictable regulatory framework and improve tax certainty.”<sup>57</sup>

#### **IV.4 Developing Country Perspective: Threat of Vicious Cycle from Tax Base Erosion**

From the perspective of a developing country, the inability to tax MNEs to the extent of its contribution to their profits erodes its legitimate tax base. This tax would then need to be collected from domestic enterprises, leading to an increase in their tax burden and consequent loss of their competitiveness, which can adversely impact economic growth as also the “ability to pay” of the consumers therein. Once that happens, even the profits derived by the MNEs from that economy will suffer, resulting in adverse consequences for every stakeholder in the global economy. One can describe it as the “vicious cycle” of defective tax application. The potential harm for the global economy as a whole necessitates that all countries are able to collect tax from profits that are derived by MNEs from contributions made by their economies to those profits.

### **V. OPTIONS AVAILABLE & INFORMED CHOICES**

The options available to a developing country in respect of TP and profit attribution are limited primarily by its treaty obligations.<sup>58</sup> In addition, developing countries may also be constrained by limited capacity and lack of appropriate data, particularly local comparables.

Tax treaties provide independent provisions for TP and attribution of profits. Thus, the first option that every developing country can exercise is to take into account its preferences and constraints in respect of them separately.

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<sup>57</sup> *ibid.*

<sup>58</sup> For instance, even though OECD guidance for determination of arm’s length price may not be binding, most developing countries would find it difficult to avoid, since MNEs would be following it in accordance with their compliance obligations in developed countries.

### ***V.1 Options for TP under Article 9 of Tax Treaties***

The provisions for TP provide a significant tool to deter artificial profit shifting by manipulation of prices of intermediate goods. Their existence, per se, does not impose any obligation on the Contracting States to apply them in each case or use them for attributing profits. This provides them reasonable flexibility regarding the extent to which they wish to invoke this provision, and how they wish to utilize it. Thus, presuming that the standard TP provisions exist in the tax treaties entered by a developing country, one can identify the options for it in respect of TP in the following matrix:

- To apply or not to apply TP
  - If applied,
    - to apply it in all / most cases, or
    - to apply it selectively with risk assessment, or
    - to apply rarely in cases of very high risk
  - If applied,
    - to apply it completely in accordance with OECD/UN guidelines, or
    - to apply it largely in accordance with OECD/UN guidelines, but deviate from it where the domestic law position differs, or
    - to apply it completely in accordance with domestic law that may or may not be in line with the OECD/UN guidelines

#### **Analysis of Options**

While selecting its preferred option in respect of TP, a developing country should take into account the complexities of TP methods, their high cost of compliance and administration, the probability of tax disputes and the benefits expected by preventing profit shifting. The expected benefits would generally be proportional to the size of the economy and international trade. The first choice to be made could be whether to apply or not apply TP. For a very small economy

lacking capacity or comparable data, the option of not applying it at all could be a viable option.<sup>59</sup>

For any developing country wishing to apply TP, the most important decision may be to decide its extent. It can opt for a uniform compliance burden on all taxpayers, but it may be preferable to limit such compliance, particularly for smaller enterprises or for small transactions, by way of reasonable thresholds. Adopting a selective audit approach based on risk assessment can mitigate high costs of administration and can be another option worth considering.

One way in which the deterrence benefits of TP can be preserved while minimizing costs of compliance and administration, is by laying down “safe harbors” or objective criteria on the satisfaction of which, taxpayers are excluded from the risk of TP audit or TP compliance.

### ***V.2 Options for Profit Attribution to PE***

In terms of profit attribution to PE, there are significant differences between the three main provisions, and the one that is part of a particular treaty will govern its application and dictate the possible options.

### ***V.3 Options under Article 7 based on UN MTC pre-2010 OECD MTC***

Article 7 in the UN MTC is the most favorable provision for developing countries, due to the “*force of attraction*” rule that allows the country of source to tax not only profits derived by the PE, but also income derived directly by the foreign enterprise from similar business. It also restricts the deduction of certain expenses made by the PE to the head office that are not linked directly with the operations of the PE. It provides the following options to a developing country regarding the application of the “direct or separate accounting method”:

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<sup>59</sup> The choice for not applying TP does not take away the obligation to provide corresponding adjustment, wherever such provisions exist in their tax treaties.

- For Direct or Separate Accounting Method
  - Apply or not apply Force of Attraction Rules
  - Limit or not limit deduction of expenses not permissible under Article 7(3) of UN Model Tax Convention

As the “indirect or fractional apportionment method” is the same under Article 7 in the UN Model and the pre-2010 OECD version of Article 7, the options available to a developing country under a treaty containing either of these provisions can be listed in the following matrix:

- For Indirect or Fractional Apportionment
  - Apportionment based on
    - Sales in all cases or
    - Expenses in all cases or
    - Working Capital in all cases or
    - Either Sales or Expenses or Working Capital depending upon the characteristics of business, as per OECD/UN commentary, e.g.
      - Sale for business in services or proprietary goods with high profit margin
      - Expenses for manufacturing or services involving raw material or high labour content
      - Working Capital for banking and financial concerns, or
    - A combination of factors, e.g.
      - Sales, Payroll and Property with equal weight or
      - Sales, Payroll and Property with a higher weight for sales or
      - Sales and Working Capital, or
    - Any other method under domestic laws or
    - facts and circumstances of the case



## **Analysis of Options**

Both these versions of Article 7 provide two methods, the “direct or separate accounting” method and the “indirect or fractional apportionment” method. Where it is possible to determine the taxable profits of a PE based on separate accounts, it is preferred, provided that it reflects profits that the PE would derive if it was a separate and independent entity. This would be the case, for example, where a PE undertakes a business completely independent from the business of the head office. However, where the PE is a part of an integrated business, the condition of “separate and independent entity” would necessitate that the PE is fully compensated on an arm’s length basis for all explicit or implicit obligations imposed on it.<sup>60</sup> It would also be important to examine whether the terms and conditions of a contract between a PE and the head office are those that would have been acceptable to a separate and independent entity, and whether the PE has been fully compensated at arm’s length for the opportunity cost imposed on it by an unfavourable obligation.

While the existence of provisions for force of attraction and restriction on deductible expenses in treaties based on the UN Model provides the Contracting States a right to apply them, they would apply them only if the domestic tax laws also provide for the same. This provides an option of applying or not applying these rules, even if the same are present in the treaty. The choice of a Contracting State not to apply them under its domestic law, of course, does not prevent or affect the right of the other Contracting State to apply them.

In cases where separate accounts are not maintained by the PE, or where they do not reflect the profits that would have been derived if the PE was a separate and independent entity, then the fractional apportionment as may be customary, can be applied. The treaty does not lay down any particular formula for apportionment, leaving it to that Contracting State to determine the factors on the basis of which such apportionment can be made.

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<sup>60</sup> For instance, an independent agent that has the opportunity of maximizing its profits serving multiple clients, will agree to a condition restricting it to serve only a single client, only if it is adequately compensated for the loss of potential profits resulting from this condition.

The OECD and UN Commentary list three factors, i.e. sales, expenses and working capital, each of which can be the basis for fractional apportionment of profits. Following their recommendation, a developing country can opt for one of these in all cases, or adopt them depending upon the characteristics of business as recommended. It is also open for it to opt for other methods, to the extent they satisfy the condition of being part of the customary practices, such as a multi-factor apportionment similar to the Massachusetts Formula followed by US States or the one proposed in the CCCTB.

#### ***V.4 Options under Article 7 based on Revised OECD Model Tax Convention (2010)***

Article 7 in the revised OECD Model Tax Convention does away with the requirement of attributing profits that a PE would have made had it been a separate and independent entity, and instead requires these profits to be determined in accordance with FAR. It also does away with the option of fractional apportionment, thereby leaving very few options to a developing country, which can be identified in accordance with the following matrix:

- To apply or not to apply FAR based TP methods for attributing profits
  - If standard methods are applied
    - Apply them in accordance with the Authorized OECD Approach (AOA) or
    - Apply them according to domestic laws where they differ from AOA
  - If standard methods are not applied
    - Adjust the results in accordance with AOA or
    - Not adjust the results in accordance with AOA

The provision allows very limited options to the Contracting States. Detailed guidance has been developed by the OECD for the application of this provision, and very little alternative guidance or literature exists that could be resorted to by the developing countries wishing to deviate from this guidance. This provision, in effect, makes profit attribution secondary to TP, thereby making it necessary for Contracting States to apply it in every case requiring attribution of profits. In the presence of this provision in the tax treaty, the country of source may find it difficult to protect its right to tax profits of the PE that have been contributed by its economy by way of demand and functioning markets.

## **VI. CONCLUSIONS AND RECOMMENDATIONS**

Economic theory recognizes the legitimate right of a tax jurisdiction to tax profits derived by foreign enterprises from its economy, to the extent of its contributions to those profits, either by facilitating demand, maintaining markets or facilitating supply. The contributions by facilitating demand and maintaining markets are best approximated by sales, which is recognized as a valid basis for the taxing right of market jurisdiction in literature, country practices as well as new proposals like CCCTB. This right is also provided in Article 7 of the UN MTC and the Article 7 of OECD MTC, prior to its revision in 2010, where both methods for profit attribution enable sales to be taken into account. The OECD Commentary also recommends sales as one of the criteria that can be adopted for fractional apportionment under this provision.

The 2010 revision of Article 7 in the OECD MTC 2010 requires Contracting States to attribute profits to PE on the basis of FAR, which represent supply, and thereby negates the contribution made by the market jurisdiction by facilitating demand and maintaining markets. This provision does not appear to conform to the basic economic rationale on which the whole edifice of modern international taxation rules, maintaining a delicate balance between the rights of the country of source and the country of residence, had been in existence. The positions documented by various countries reflect the unlikelihood of its universal acceptance anytime in the near future.

This also poses complex challenges for developing countries in terms of TP and profit attribution practices. Where a treaty retains a provision based on the Article 7 of the UN MTC or the pre-2010 version of the OECD MTC, TP and profit attribution can be considered as independent processes, and a developing country may choose options in respect of them separately. Under such a provision, a developing country has a right to attribute profits to a PE by fractional apportionment, either by relying on sales, expenses or working capital, as recommended in the OECD and UN guidance, or by resorting to a combination of these factors, as advocated in literature. Where a treaty includes profit attribution provision based on the revised Article 7 introduced in the OECD MTC 2010, profits to a PE are required to be attributed on the basis of FAR analysis, making adoption of TP a *fait accompli*.

Based on this analysis, it can be recommended that where the treaty permits, as in Article 7 based on the UN MTC or pre-2010 Article 7 of the OECD MTC, a developing country should consider various options for TP and profit attribution, and opt for them independently, depending upon its economic interests and policy preferences. These options include selective application of TP and attributing profits by apportionment based on factors that include sales.

A developing country that wishes to secure its rights to tax profits of a PE that have been contributed by its economy may prefer to retain Article 7 based on the UN MTC or pre-2010 Article 7 of the OECD MTC in its tax treaties. Under this provision, wherever the direct or accounting method for determining profits attributable to PE is not applicable, it should consider opting for fractional apportionment as permitted in paragraph 4 of that article, and include sales as one of the factors for such apportionment. In addition, it can also opt for applying TP methods on a selective basis, for preventing artificial profit shifting, as permissible under Article 9 of MTCs.

# CHAPTER 4

## TRANSFER PRICING: CONCEPTS AND PRACTICES OF THE “SIXTH METHOD” IN TRANSFER PRICING<sup>1</sup>

Verónica Grondona

### I. INTRODUCTION

The Sixth Method was first introduced by Argentina as the sixth paragraph following the fifth paragraph of Article 15 of the Profit Tax Law.<sup>2</sup> It is called the Sixth Method because it was incorporated after the other five methods for transfer pricing valuation which consist of the traditional transactional methods (the Comparable Uncontrolled Price Method, the Resale Method and the Cost Plus Method); and the transactional profit methods (Transactional Net Margin Method and the Profit Split Method), recommended by the 1995 Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. The Sixth Method is applicable to commodities and is distinct because it draws a comparison with a market quote, instead of allowing the comparison to be made with transactions and prices agreed between unrelated parties (Grondona, 2015) (Grondona & Knobel, 2017).

The Sixth Method has been legislated by Argentina, Bolivia, Brazil, Costa Rica, the Dominican Republic, Guatemala, Honduras, Peru, Uruguay and some Caribbean countries; but also by Zambia, Malawi and India; because it has a number of advantages. To date, practical experience with the rule exists mainly in Argentina, Brazil, Ecuador and Uruguay, which have different experiences in applying it.

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 2 (May 2018).

<sup>2</sup> Profit Tax Law (“*Ley de Impuesto a las Ganancias*” -LIG-, in Spanish), text organized in 1997 and its modifications.

The advantages of the Sixth Method are that a quoted price can provide a clear and relatively objective point of reference to challenge the prices attributed in transactions between related entities. In some circumstances it may be possible to identify such a price which can be used as an appropriate benchmark, usually with some modifications, if applying it seems to result in an appropriate level of profit. This can establish a basis for rules which are easy to administer and do not involve either subjective judgment or detailed examination of facts and circumstances. However, the experience of its application in different countries shows that some loopholes have been left open that have reduced the benefits to be expected from its application.

This chapter analyses the problem of the valuation of commodities in section 2, actual policy experience in section 3 and the policy's impact and the lessons learned in section 4.

## **II. THE PROBLEM OF THE VALUATION OF COMMODITIES<sup>3</sup>**

The central problem underlying the commodity transactions between two related parties is the lack of validity of the price settled by such an agreement. Independent parties trading commodities settle their agreements in open markets and if the transaction is done between the producer and the trader, it is normally based on future prices.

While transactions of commodities between related parties have been found on many occasions to be settled without an agreement and often involving trading and transport related companies located in low or zero tax jurisdictions;<sup>4</sup> exports of commodities to non-related parties have been found to also involve intermediates with no economic substance located in low or zero tax jurisdictions.<sup>5</sup>

Moreover, regarding transactions within economic groups, these are generally vertically-integrated, so that the commodity is

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<sup>3</sup> Relevant parts of this section have been extracted from BMG (2015a) and CIAT (2013).

<sup>4</sup> See appendix for a brief description of Argentine court cases relating to the application of the Sixth Method.

<sup>5</sup> See Argibay Molina (2013).

transferred to the related party for processing and perhaps eventual use in manufacturing; or they are large diversified commodity traders and brokerages. This gives rise to a range of problems for tax authorities seeking to establish an appropriate level of profit for the commodity producing subsidiary of such a group.

First is the question of risk. Due to the characteristics of the extractive industries producing such commodities, the producer faces risks resulting either from natural causes (i.e. the weather) or from the volatility of the markets which often produce wide price fluctuations, or indeed both. An independent producer can try to manage such risks by using forward contracts, and may also benefit from knowledge of published prices where there is organised trading of derivative contracts based on relevant commodities. However, an integrated firm can internalise this risk management, by combining the relative security of supply due to involvement in production, with the management of stocks and ultimate delivery. Often, it assigns the trading activity to an affiliate to which it attributes substantial risks and capital, in order to justify the fact that it receives a disproportionate profit margin.

Secondly, the commodity supply chain often includes a number of other activities which are generally internalised within integrated corporate groups, such as logistics, insurance, transportation and commercialisation. Like commodity trading, these functions may also be assigned to separate affiliates which, because of the nature of the functions concerned, can easily be organised so that their profits are attributable to jurisdictions where they will be subject to low levels of taxation. Thus, commodity producing countries face the situation where the profits attributable within an integrated firm to physical production are often far lower than those to related service activities. Since such service activities are easily organised in such a way as to bear low taxes, this is a major source of base erosion and profit shifting (BEPS). The BEPS effect in respect of transactions with commodities and the extractive industry is possibly even more critical for developing countries than similar practices in other sectors of the economy. This is due to the primary importance and key nature of this industry for the economies of many developing countries and thus inherent reliance

and dependency of the state budgets of these countries on the tax revenues from these commodity producing or extracting activities; as well as from the foreign currency obtained in such trading.

In this context, the standard OECD approach to transfer pricing is clearly unsuitable. The OECD Guidelines (1995) (2010) specify that the starting point in evaluating the profits of associated enterprises should be the transactions between them, which are supposed to be evaluated by reference to comparable transactions between unrelated entities. However, it should be clear that a transaction between related parts of an integrated corporate group has none of the characteristics of a contract freely negotiated between truly independent parties, since all of its terms and conditions will have been decided administratively and aimed at maximising the benefits to the firm as a whole. Indeed, in the case of primary commodity production, the producing affiliate will generally be very much subordinate to the concerns of the firm's head office, which is likely to focus on the upstream and marketing aspects of the business. Therefore, such contracts cannot be considered the starting point. Recognising the lack of suitable comparables in many cases, the OECD has increasingly moved towards the attribution of profits based on the functions performed, assets owned and risks borne by the various affiliates. This also is unsuitable, since multinational enterprises (MNEs) design corporate structures involving functional fragmentation frequently with BEPS objectives, as described above.

### **III. ACTUAL POLICY EXPERIENCE**

For the reasons described in Section 2 above, several countries have adopted an alternative method for the valuation of commodities: the Sixth Method, which basically consists of comparing the price of the exported commodities with an international quotation of such goods at the shipping date.

The Sixth Method has been adopted by a number of developing countries because it has a number of advantages, but they have also in practice experienced difficulties applying it. Its advantages are that a quoted price can provide a clear and relatively objective point of reference to challenge the prices attributed in transactions



between related entities. In some circumstances it may be possible to identify such a price which can be used as an appropriate benchmark, usually with some modifications, if applying it seems to result in an appropriate level of profit. This can establish a basis for rules which are easy to administer and do not involve either subjective judgment or detailed examination of facts and circumstances.

The difficulties which have been experienced are both in identifying a suitable benchmark and because, once such a benchmark has been established, it is possible for the firm concerned to organise the transactions between its affiliates to take advantage of it. An important element in this is that transfer pricing documentation is generally presented to the tax authorities after the transaction has been made, enabling the adoption by the taxpayer of the most advantageous quoted price; and the impossibility of considering an agreement between two related parties as sufficient proof of the date of settlement of the price of the commodity transaction.

The method in issue is in place in countries such as Argentina, Bolivia, Brazil, Costa Rica, Dominican Republic, Guatemala, Honduras, Peru, Uruguay and some Caribbean countries; as well as in Zambia, Malawi and India. To date, practical experience with the rule exists in mainly Argentina, Brazil, Ecuador and Uruguay. However, the method is not applied unequivocally the same in all these countries.

### ***III.1 Legal Framework and Court Decisions in Argentina<sup>6</sup>***

The Vestey case was one of the first export cases exposed for its tax evasion consequences in Argentina. A Senate commission created in 1934 to analyse the consequences of the Roca-Runciman pact<sup>7</sup> between Argentina and the United Kingdom (UK) revealed that the Anglo-Argentinean meat-packing company (Vestey) was paying no taxes in Argentina or in the UK. Senator De la Torre then suggested, in a public speech in the Congress,

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<sup>6</sup> Relevant parts of this section have been extracted from Grondona, Knobel (2017). In this section, only court cases that have resulted in legislative changes are mentioned.

<sup>7</sup> According to the Roca-Runciman pact, the UK agreed to keep buying Argentine meat, as long as its price was lower than that of other suppliers.

that for the purposes of calculating the income attributable to Argentina, the transaction prices should be based on the meat prices in Great Britain (CIF),<sup>8</sup> less the cost of transportation and insurance calculated by the Argentine government. This was considered as a possible solution to the problem because it had been observed that the import price in the UK was significantly higher than the export price in Argentina; and as from 1943 an article known as the “import-export clause” was introduced on the Income Tax Law (LIG) with such consideration.<sup>9</sup>

The rule in place treated the difference between a wholesale price at origin and the importers’ price as implying an economic linkage between the parties.

When a wholesale price was not available, the arm’s length criteria would be applied;<sup>10</sup> i.e. a comparison with the profits of independent entities could be used for the calculation of the profits of the Argentine source, although it was not very clear what was meant by a “comparison with the profits of independent entities”.

The economic reality principle was first introduced into Argentine law in 1946, and is still quoted in the Federal Act on Tax Procedures, which provides that it should be the true substance of a taxable event and not the legal forms or structures used that needs to be considered for the determination of the taxable base.<sup>11</sup> The National Supreme Court of

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<sup>8</sup> CIF is the price at destination including the costs of carriage, insurance and freight (CIF).

<sup>9</sup> Article 7 of Decree 18.229/1943 required that the value of exported goods, for the purpose of the determination of income, should be established “(...) subtracting from the wholesale price at destination the cost of such goods, transport and insurance expenses, sales commissions and expenses, and other expenses incurred in Argentina”; while the value of imported goods should be determined based on the wholesale price at origin plus transport and insurance costs to Argentina.

<sup>10</sup> Since 1946 for export cases, and since 1973 to export and import cases.

<sup>11</sup> However, such criteria were not applied to transfer pricing cases until 1961, when the tax court ruled in the case of *Refinerías de Maíz*. The case was brought to the National Supreme Court of Justice (CSJN, Spanish acronym), and on 10 June 1964, the CSJN ruled that royalty payments should be considered contributions to the income of the parent company (deemed dividends) and could not be deducted for income tax calculation purposes, since the parent company owned 96 per cent of the stocks of the Argentine affiliate, and hence such enterprises could not be considered to be independent. The underlying argument was the economic reality principle.

Justice (CSJN, Spanish acronym) applied this economic reality principle in several other cases relating to interest loans and royalty payments, and even merchandise transactions within the domestic market, in 1973 and 1974.

Between 1973 and 1974, Law 20.628 on income tax (hereinafter “LIG”, for its Spanish acronym), Law 20.557 on foreign capital investment, and Law 20.794 on technology transfer were enacted, establishing the legal doctrine which arose out of these rulings of the CSJN,<sup>12</sup> which had determined that it was the substance (the “economic reality”) and not the legal form which was relevant, and that in view of this it was valid to disregard contractual arrangements between entities belonging to the same economic group. This doctrine stressed that such contracts had not been made between legally independent parties, either for operations within a country or with entities located abroad.

The civilian-military coup of 24 March 1976 was supported and encouraged by local and foreign multinational entities. Changes to the legislation affecting MNEs’ investment interests in Argentina were among the first to be made, thus, since the economic reality principle was argued by MNEs to be too hostile to foreign investment, it was modified at a very early stage in the dictatorship. So, in August 1976, a new foreign investment law was passed validating contracts between related entities provided that they conformed to normal market practices between independent parties. The same modifications were soon after introduced to the LIG, and to the law on technology transfers. Thus, the arm’s length principle was re-introduced *de facto* in the legislation.

In 1983, the CSJN<sup>13</sup> ruled in favour of the taxpayer, in *Eduardo Loussinian S.A.C.I.F.I.A.* The Tax Administration Department had challenged what it considered to be schemes to over-invoice imports, noting that a difference between the price paid and the current wholesale price in the place of origin supposed the existence

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<sup>12</sup> A description of these rulings and their implications, and an analysis of the regulatory changes which resulted, can be found in Martínez de Sucre and Corti (1976), Corti (1985), and Corti (2012).

<sup>13</sup> In Argentina, tax decisions including transfer pricing-related rulings, once the administrative process is complete, can be challenged legally at three levels (in ascending order): the National Tax Court (TFN); the National Federal Administrative Litigation Appeal Chamber (CCAF); and the National Supreme Court of Justice (CSJN).

of an economic linkage between the foreign company and the local importer; and that therefore this difference in prices constituted a net Argentine-source profit for the exporter, according to Article 8 of the LIG. Nevertheless the CSJN took the view that it was not possible to verify whether there was an economic linkage (ownership relationship) between the foreign entities and *Eduardo Loussinian S.A.C.I.F.I.A.*; and therefore the profit could not be said to be of Argentine source.

In 1992, the worldwide income principle was incorporated into the LIG. This applied to all residents in Argentina, including companies and their foreign subsidiaries.<sup>14</sup> It provided that residents should calculate their taxable base on the total profits gained in the country and abroad, while they could deduct from their local income tax liability the actual payments made for similar taxes abroad.

Many changes were introduced into local legislation from 1998 onwards in relation to the treatment to be given to transactions between related parties, most of them aimed at making local rules consistent with the OECD approach (Baistorcchi, 2012). In this way, the five transfer pricing methods specified in the 1995 OECD Guidelines (OECD, 1995) (comparable uncontrolled price (CUP), resale price minus, cost plus, profit split, and the transactional net margin method (TNMM)) were introduced in the LIG at this point.

Probably as a consequence of *Eduardo Loussinian SACIFIA*, the export-import clause was modified in 1998 in order to make it applicable even when the economic linkage between the parties cannot be verified.<sup>15</sup>

<sup>14</sup> It was not until the modifications to the LIG introduced by Laws 25.063, in 1998, and 25.239, in 1999, that the treatment to be given to foreign subsidiaries was clarified. For a brief discussion on the treatment given between 1992 and 1998 to profits of foreign sources, see Gilardo (2007).

<sup>15</sup> Law 25.063 of 7 December 1998 modified Article 8 of the LIG. Also, Decree 485 of 7 May 1999 introduced equivalent changes in Article 11 of the Regulatory Decree 1344/1998. Before these changes, the regulations under the LIG, approved by Decree 1344 of 19 November 1998, indicated in Article 11 of Decree 1344/1998 that once the existence of an economic relation had been verified (Article 8 of the LIG) the Argentine Federal Administration of Public Revenue (AFIP, Spanish acronym) could also determine the value attributed to the products involved in the transaction taking the wholesale price in the seller's market in case of an export, or the wholesale price in the buyer's market in case of an import. In any case, when the real prices of export or import were respectively higher or lower, such prices should be considered.

The export-import clause was amended again in 2003,<sup>16</sup> to provide that in cases of transactions with related parties, as well as with parties located in low or zero tax jurisdictions, the OECD methods should be applied. Also, in cases of imports or exports for which an international price could be established in a transparent market, such a price should be applied to determine the profit of the Argentine source.

Finally, the same law amending the export-import clause incorporated a sixth paragraph after the five OECD methods, applying to "...exports made to related parties, that relate to cereals, oil products, and other products of the earth, hydrocarbons and its by-products, and, in general, goods that have a known quote in international markets, in which an international intermediary is involved that is not the effective recipient of the merchandise", under which prices should be based on "the trading value of the goods in a transparent market on the date on which the goods are shipped". The application of this Sixth Method is specifically required only when the foreign intermediary cannot demonstrate economic substance.

In this sixth paragraph, economic substance is defined as a) having real presence in the territory of residence, and assets, functions and risks of a similar weight to the volumes of transactions negotiated; b) its main activity must not constitute the obtaining of passive income, nor the intermediation of sales of goods from and to Argentina or with other members of the economic group; and c) its foreign trade operations with other members of the same economic group do not exceed 30 per cent of the total annual turnover of the entity. These conditions are cumulative, not alternative.

It should be noted that the Sixth Method can be applied to third party transactions in Argentina. However, something not addressed in the rule is the role of the transport and trading, which are a very important part of the BEPS problem in commodity trading. In some sectors, such as oil, international quotes can also be found for the logistics, insurance and transport between, for example, Buenos Aires and the international market used for the quote (e.g. Chicago).

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<sup>16</sup> Modifications introduced by Law 25.784 of 2003.

For customs information, the INDIRA system gives the Argentine Federal Administration of Public Revenue (AFIP, Spanish acronym) access to micro data (volumes, prices, invoicing details, etc.) from Argentina and other MERCOSUR countries, as well as some others, such as India. An agreement has been signed with the United States, and with India, for sharing customs information, although not through the INDIRA database, since it is restricted to a bilateral exchange. However, customs data does not distinguish between related and unrelated parties. Customs micro data in this system – which works like an online database – can be accessed immediately and automatically by national tax officials, who send the information on mismatches found to the regional agency conducting the audit.

On December 2017, the Sixth Method was modified in the context of a series of modifications that were made to the LIG. Such modifications affected the Sixth Method by making it applicable only to cases in which the taxpayers are involved in import and export transactions via an intermediary that is a related party, or via an intermediary that is located in a non-cooperative jurisdiction or a low or null tax jurisdiction, or in which the exporter at origin and the importer at destination are related parties. In such cases, the contracts will need to be registered in the Tax Administration detailing the comparability differences that justify the difference in price to a relevant market quote at the delivery date of the goods; as well as other elements explaining for primes or discounts applied. If no contract is registered, or if the contract is registered but does not comply with the requirements listed above, then the valuation of the export of commodities will be made considering the value of a quote at the shipping date, after considering the necessary comparability adjustments. Finally, the legislation was changed in order to introduce a revenue threshold -to be defined by the Tax Authority- above which transfer pricing requirements (including the Sixth Method) would be applicable.

The OECD's BEPS Action Plan discussed the Sixth Method in its Action 10. The proposals under Action 10 suggest that what had been known as the Sixth Method should be understood as a quoted price under the "comparable uncontrolled price".

Even when both the Sixth Method and OECD’s CUP Method seem to be similar, the CUP Method is based on the arm’s length principle, and thus aims at looking for prices set between independent parties that have performed transactions “comparable” to those between related parties. Searching for comparable transactions between independent parties is often very complex, on one side because of the lack of available information; but also, and not less important, because transactions between related parties, performed between one party and another party subject to it, are in essence not comparable to transactions performed between two parties that are in equal conditions to negotiate a contract. The Sixth Method simplifies the problem by defining how the comparability should be done, providing greater certainty both for the taxpayer and the Tax Authorities, and reducing compliance costs.

In addition, the OECD version of the Sixth Method<sup>17</sup> allows for the use of quoted prices on other days and other valuations by MNEs and not only the international quoted prices at the shipping date. However, given that transactions of commodities between related parties are set between one party and another party subject to it, there is no other date that reflects a real transaction except from the shipping date. This is clear when observing the experience from court cases in Argentina described in Appendix 1 to this chapter, where in one case (*Oleaginosa Moreno*) it was found that the company set its prices with independent parties at the shipping date; and in other cases (*Cargill*, and *Oleaginosa Moreno*) it was found that there was no written arrangement between the related parties that could allow for the identification of an alternative date.<sup>18</sup>

However, as can be seen in Appendix 1, the Argentine Tax Authority has exploited the similarities between the Sixth Method and the CUP in order to defend the use of international quotes at the shipping date in cases that related to fiscal years that were prior to the year in which the Sixth Method was introduced in Argentine legislation (2003).

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<sup>17</sup> See OECD (2017).

<sup>18</sup> It should be noted that if such written arrangement did exist, it should not be considered as a contract, since a contract is legally understood to be an arrangement between two parties with equal negotiating conditions.

### ***III.2 Other Similar Systems in Latin America***

Several countries have lately incorporated new legislation or modified existing legislation in order to adapt it to the outcome of OECD's BEPS Action 10.

According to the United Nations Transfer Pricing Manual (UN, 2017), and CIAT (2013), Latin American countries have implemented the Sixth Method for the valuation of commodities in international transactions as follows:

**Table 1. Different approaches to the implementation of the Sixth Method**

Aspect	Adopted approach
Transactions covered	<ul style="list-style-type: none"> <li>• Only export transactions</li> <li>• Only import transactions</li> <li>• Import and export transactions</li> </ul>
Nature of the measure	<ul style="list-style-type: none"> <li>• A way of applying the CUP Method</li> <li>• A way to arrive to an arm's length price</li> <li>• A separate method</li> </ul>
Products or goods subject to the measure	<ul style="list-style-type: none"> <li>• Commodities</li> <li>• Renewable natural resources and / or non-renewable natural resources</li> <li>• Goods with known quotes in transparent market</li> <li>• Some regulations allow tax administrations to extend the measure to other goods provided that those meet certain requirements</li> <li>• The international intermediary does not have economic substance</li> <li>• And/ or the tax agency considers it appropriate</li> </ul>
Relation condition	<ul style="list-style-type: none"> <li>• Some countries define the condition by which the international exporter and / or intermediary trader and / or the exporter at origin and the importer at destination are related parties.</li> </ul>



	<ul style="list-style-type: none"> <li>• Some apply the method whenever the foreign company is resident in a listed jurisdiction (non-cooperative, low tax jurisdiction, or under a privileged tax regime), regardless of whether the companies involved are related enterprises.</li> </ul>
<p>Hierarchy of the method</p>	<ul style="list-style-type: none"> <li>• Mandatory if the conditions established in the regulation are met;</li> <li>• Optional, either this measure or the CUP method, or other OECD methods may be applied;</li> <li>• Not expressly established by the regulation</li> </ul>
<p>Prices to be considered</p>	<ul style="list-style-type: none"> <li>• Exports and imports are afforded different treatment:             <ul style="list-style-type: none"> <li>• For exports: research on international prices in accordance with the terms agreed upon by the parties as of the last shipment date unless there is evidence that it was agreed on another date;</li> <li>• For imports: the price may not exceed the price based on international parameters as of the date on which they were originally purchased</li> </ul> </li> <li>• Multiple criteria in a single regulation: (i) price on the transparent market on the loading or unloading date; (ii) average price over a 4-month period or 120 days prior to unloading or after loading; (iii) price as of the date on which the agreement was executed; (iv) average price over a 30-day term after the agreement was executed; (v) quoted price on the transparent market on the loading date, that of the prior date in which a quoted price was available or that of the first day the goods are loaded (the criterion adopted varies by country)</li> </ul>

Comparability adjustments	<ul style="list-style-type: none"> <li>• Some countries allow for comparability adjustments to the publicly available price so as to take into account market circumstances, contract terms and conditions, and product quality and specifications whereas other countries do not accept comparability adjustments.</li> </ul>
Exemptions to applying the rule	<ul style="list-style-type: none"> <li>• Some measures provide the local taxpayer with the possibility to evidence that the intermediary has economic substance and thus be exempted from applying the rule, even though the criteria are not the same in every case.</li> <li>• Some countries exempt the application of the Sixth Method if an agreement is filed with the tax agency or with any other government agency a few days after it has been signed.</li> </ul>

Source: Author's based on UN (2017), CIAT (2013).

In this sense, Uruguay applies the method in a similar way to Argentina (until December 2017): to transactions with related parties, in which an international intermediary is involved that is not the effective recipient of the merchandise, and that does not have economic substance (as understood by Argentine legislation) involving commodities; and the comparison is made with a quote in a transparent market at the shipping date.<sup>19</sup>

<sup>19</sup> In the comments to the OECD's Discussion Draft on the valuation of cross border transactions (OECD, 2015), there is some confusion between the interpretation of the Argentine legislation made by the tax authorities and the courts, and the Sixth Method itself; and on some replies, the Uruguayan Sixth Method is described as providing more certainty. However, it needs to be understood that the difference in interpretation of the Sixth Method in both countries could be based on the evolution of Argentina's legislation up to the moment of the Sixth Method. Such historical process evolved from the use of the import and export clause which considered that the highest price between the price of the export and that of the wholesale price at destination should be the one to be taken to the application of the Sixth Method in cases where an intermediary without economic substance was used and an international quote was available.

Peru recently introduced several modifications to its transfer pricing rules<sup>20</sup> in order to adapt them to the OECD BEPS Action Plan, changing the Sixth Method in order to be applicable as a benchmark for export and import transactions with known quotations in international markets, the local market or the destination market (including those of the derivative financial market).

Ecuador<sup>21</sup> also had some recent modifications in its transfer pricing regulations,<sup>22</sup> and particularly in relation to the Sixth Method in order to adapt it to a CUP Method with specific benchmarks for export transactions of banana, crude oil, gold, silver, copper and any other mineral metal in any State. This methodology is to be applied in transactions with parties located in tax havens or jurisdictions with preferential tax regimes; or in transactions with international intermediaries that do not have a tax residence in the jurisdiction of the final destination of the goods. The benchmarks are the monthly average for crude oil, the price used for the calculation of royalties for the mining sector, and the minimum export price set for the banana sector.

The Dominican Republic applies the Sixth Method in export transactions to related party effective recipients of products which have a known quote, that have been performed by intermediaries that are not related parties. The adjustment is based on an international quote of the good in a transparent market on the first day of the shipping, except when the intermediary has a real and effective presence in the jurisdiction of residence and is mainly dedicated to intermediation.

In Paraguay,<sup>23</sup> transfer pricing adjustments for exported merchandise with an international known price in transparent markets, stock exchanges or similar, should be established based on such prices at the day in which the shipping has finalized or in the

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<sup>20</sup> Legislative Decree 1312 of December 2016.

<sup>21</sup> There are some court cases on the banana, flower and lumberjack markets that would be interesting to analyse further in another study.

<sup>22</sup> Resolution No. NAC-DGERCGC16-00000531 of the Ecuadorian Tax Authority (SRI, Spanish acronym).

<sup>23</sup> Law 5061/13.

day previous to a date in which there is a quote. The triangulation of the transaction through an intermediary that is not the effective recipient of the merchandise is not a requirement for the application of this rule. The Paraguayan legislation also observes that conditions would be set by the authorities on how to apply the adjustments in the case of operations agreed in future markets.

It should be noted that Paraguay, Uruguay and as from December 2017, Argentina, require the registration of contracts involving the export and/or import of commodities, detailing the conditions agreed in such transactions.

In Brazil,<sup>24</sup> the application of the export quotation price (for which the Portuguese acronym is PECEX) is mandatory in the case of export of commodities made to i) related parties, ii) resident in a jurisdiction with a favourable taxation, or iii) entities that benefit from differential fiscal regimes. Commodities are defined as the products subject to public quotation in stock exchanges and future markets, or subject to public prices in internationally recognized sectorial research institutions (the commodities subject to PECEX are listed in the legislation), or traded in stock exchanges and future markets listed in the legislation. The PECEX is not a method, but a specific comparable transaction which is calculated as the median daily value of products with a quotation in stock exchanges and future markets of internationally recognized raw materials. The prices used are those at the date of the transaction. The shipping date is only used if the settlement date has not been identified.

### ***III.3 Implementation in African Countries***

Zambia has introduced rules that apply to the sale of base metals or any substance containing base metals or precious metals between related parties. In such transactions the sale price for tax purposes will be broadly the monthly average quoted price on metal exchange markets (OECD, 2014).

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<sup>24</sup> Normative Instruction RFB 1312 modified by Normative Instruction RFB 1395 of September 13, 2013, subsection V, article 34.

Practice Note 1/2008,<sup>25</sup> paragraph 3.17 introduced a version of the Sixth Method for the purposes of the Corporate Income tax.<sup>26</sup> In Zambia’s case, the introduction of the Sixth Method was made through the introduction of a reference price for any transactions relating to the

*...sale of base metals, precious metals or any substance containing base metals or precious metals, directly or indirectly, between related or associated parties.*

The “reference price” means:

- a) the monthly average London Metal Exchange cash price;
- b) the monthly average Metal Bulletin cash price to the extent that the base metals or precious metal prices are not quoted on the London Metal Exchange;
- c) the monthly average cash price of any other metal exchange market as approved by the Commissioner-General to the extent that the base metal price or precious metal price is not quoted on the London Metal Exchange or Metal Bulletin; or
- d) the average monthly London Metal Exchange cash price, average monthly metal market exchange cash price approved by the Commissioner-General, less any discounts on account of proof or low quality or grade.

A recent study indicates that both the Zambian Revenue Authority (ZRA) and mining companies have had a positive experience of the sixth method. (Readhead, 2017)

Recently (in June 2017) Malawi has adopted some of the wording from the African Tax Administration Forum (ATAF) Suggested Approach to Drafting Transfer Pricing Legislation:

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<sup>25</sup> Practice Note 1/2008 also introduced a Norm Value for the payment of royalties on the production of minerals (paragraph 4.3), and Practice Note 2017 updated the royalty rates.

<sup>26</sup> Zambia Revenue Authority, Unofficial Consolidation of the Income Tax Act, 2017, Section 97A(13) and (14).

*for the export or import, involving grains, oil, seeds, other agricultural products obtained from the land, hydrocarbons and derivatives thereof, and, in general, goods where prices can be obtained at the date of the transaction from an international or domestic commodity exchange market, or from recognized and transparent prices reporting or statistical agencies, or from any other index but excluding all auctions in Malawi trading coffee, macadamia nuts, tea or tobacco, that is used as a reference by unrelated parties to determine prices in transactions between them (hereinafter referred to as the “publicly quoted price”), the monthly average of that publicly quoted price of the month in which the goods are shipped, regardless of the means of transport, shall be, without considering the price that was agreed upon with the related person, the sale price used for the purpose of computing the taxable income of that person unless the person provides all of the evidence needed to show that adjustments are appropriate to that quoted price to be consistent with the arm’s length principle:*

*Provided that in the case of goods exported from Malawi where the price agreed upon between the person and the related person is higher than the publicly quoted price at the above-mentioned date, the agreed price in this case will be considered as the sales price for the purpose of computing the seller’s taxable income in Malawi.*

#### **IV. ANALYSIS OF THE POLICY’S IMPACT AND LESSONS LEARNT FROM ARGENTINA<sup>27</sup>**

The AFIP monitors the spontaneous adjustments<sup>28</sup> made to the tax base by the taxpayers themselves in their transfer pricing declarations.

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<sup>27</sup> Relevant parts of this section have been extracted from Grondona and Burgos (2015) (2016).

<sup>28</sup> Spontaneous adjustments occur when an entity has presented its tax declarations, but when later filing the transfer pricing report and forms observes that it cannot justify the value of the transactions under the current legislation, and thus makes “spontaneous adjustments” to its taxable base.

**Table 2. Spontaneous adjustment to the tax base and income tax, as a consequence of adjustments to the price of commodities**

Fiscal Year	Number of taxpayers	Adjustment to the tax base (Argentine pesos)	Tax value (35%) in Argentine pesos
2003	13	369,624,402.04	129,368,540.71
2004	40	226,928,170.78	79,424,859.77
2005	11	121,367,737.80	42,478,708.23
2006	7	359,692,301.95	125,892,305.68
2007	4	974,886.17	341,210.16
2008	4	591,030.15	206,860.55
2009	6	6,479,686.64	2,267,890.32
2010	3	11,285,639.30	3,949,973.76
2011	4	4,248,810.86	1,487,083.80

Source: Elaborated based on Echegaray, Michel and Barzola (2013, p. 110)

The AFIP interprets the reduction of the spontaneous adjustments to the tax base over time as a consequence of taxpayers giving traders an alleged “economic substance” in order to avoid the application of the Sixth Method for the valuation of commodities (Echegaray, Michel, & Barzola, 2013, p. 110).

It is also possible to make some analysis of the data collected in tax declarations relating to transfer pricing and the transfer pricing

documentation presented by MNEs. From such information, the AFIP can analyse the conduct of the MNEs by economic sector, analyse what is reported in relation to transfer pricing, and analyse the conduct of MNEs in relation to specific transactions. Such information is confidential, and is used by the AFIP for research purposes in order to plan a strategy for tax audit, but also to evaluate the effectiveness of the transfer pricing regulations.

An example of the use of such information for measuring the effectiveness of transfer pricing regulations is seen in the following table, in which an analysis was made of the price differences between origin and destination of Argentine commodity exports by large concentrated export groups (mainly linked to the oil and oilseeds sector) when using different intermediaries.

**Table 3. Various triangulation situations found by the AFIP since 2009**

Argentina	Intermediary	End client	Price difference
Dutch Capital	Related company in Asia	China, Europe, Brazil	5%
US Capital	American branch	China, Spain, Malaysia, India	5%
German Capital	Parent company in Europe	China, Spain, Brazil, Chile	5% - 10%
Argentina	American branch	China, Spain	5% - 10%
US Capital	US parent company	China, Saudi Arabia, Syria	5%

Source: Echegaray, Michel and Barzola (2013, p. 86).



**Case study: the Argentine soybean exports case<sup>29</sup>**

The exports of soybean, soybean oil and soybean meal represented 24% of all Argentine exports in 2013, 22% in 2012, 24% in 2011, and 25% in 2010.

**Table 4. Soybean exports in Argentine total exports**

Year	2010	2011	2012	2013
Soybean meal	12%	12%	13%	14%
Soybean oil	6%	6%	5%	5%
Soybean	7%	6%	4%	5%
Subtotal	25%	24%	22%	24%

Source: Trademap

In a study by Grondona and Burgos (2015), eight companies dedicated to the export of soybean and related products have been selected for analysis. This selection is based on a list of companies fined by the Argentine tax authorities for paying export duties below the level required for soybean exports. These firms referenced an outdated export duty; lower than that in place at the moment of the purchase of the grains to be exported. (Gaggero, Rua, & Gaggero, 2013, p. 78)

Table 5 shows each of the exporters chosen for analysis, the group they belong to, and the jurisdiction where headquarters are located.

<sup>29</sup> Relevant parts of this section have been extracted from Grondona and Burgos (2016) (2015).

**Table 5. Exporters, Group Membership and Headquarters Location**

Exporter	Group to which it belongs	Headquarters	Jurisdiction of location of headquarters
Aceitera General Deheza	Urquía Group	Aceitera General Deheza S.A.	Argentina
Bunge	Bunge	Bunge Limited	Bermuda
Cargill	Cargill	Cargill, Inc.	United States
Dreyfus	Louis Dreyfus	Louis Dreyfus Holding B.V. <sup>30</sup>	Netherlands
Nidera	Nidera	Nidera B.V.	Netherlands
Oleaginosa Moreno	Glencore	Glencore plc	Switzerland
Toepfer	ADM	Archer-Daniels-Midland Company	United States
Vicentin	Vicentin	Vicentin S.A.I.C.	Argentina

Source: Based on company websites, annual reports and Gaggero, Schorr, Wainer (2014, p. 107)

<sup>30</sup> LDC Argentina S.A. has been controlled since 2007 by Galba SA (75 %), a company resident in Switzerland, and related to LDC. The headquarters of the LDC group are in the Netherlands. Ultimate control is in a trust named Akira, whose beneficial owner is the Luis Dreyfus family.

The exports of these companies represented 69% of soybean meal exports in 2013; 67% of soybean oil exports; and 48% of the soybean exports.

**Table 6. Companies’ share of Argentine soybean exports**

Year	2010	2011	2012	2013
Soybean meal	73%	68%	67%	69%
Soybean oil	81%	71%	71%	67%
Soybean	61%	51%	46%	48%

Source: Trademap and Penta Transaction

Soybean exports are less significant because soybean oil and meal is processed by the multinational companies and subsequently exported. This processing implies higher entrepreneurial content in soybean meal and oil exports, and lower in soybean, where there is some participation of national exporters and cooperatives.

Grondona and Burgos (2015) (2016) compare the average price of daily customs registrations between 2010 and 2013 with the price of an international quote on the shipment date.

This methodology is the closest to what is known as the “Sixth Method” in transfer pricing. In Argentina, the Sixth Method is not applicable when the tax payer can demonstrate that the foreign intermediary has economic substance. In such case the best of the five remaining methods prescribed by law should be applied. These are based on the “arm’s length” principle.

The comparison was drawn with price quotes on the Gulf of Mexico, which is one of the markets for soybean products; the other is Chicago.<sup>31</sup>

Applying the methodology outlined above, the average mis-invoicing of exports in the soybean sector was close to 10%, amounting to as much as US\$1,500 million per year.

**Table 7. Soybean Export under-pricing**

Year	Soybean meal	Soybean Oil	Soybean	TOTAL
2010	-672.689.866	-327.886.389	-242.665.029	-1.243.241.284
2011	-553.279.766	-257.674.139	-117.655.984	-928.609.890
2012	-1.134.870.549	-163.414.113	-212.319.241	-1.510.603.903
2013	-717.142.518	-251.908.091	-168.319.051	-1.137.369.659
2010	-11%	-10%	-8%	-10%
2011	-8%	-7%	-4%	-7%
2012	-16%	-5%	-15%	-13%
2013	-10%	-10%	-9%	-9%

Source: Reuters and Penta Transaction

Export over-invoicing did not exceed 2% over the same period.

<sup>31</sup> In the specific case of Argentina, the Ministry of Agriculture also publishes soybean product prices used by the Tax Authority for the application of the sixth method, but these are not market quotes. These prices follow those on the Gulf of Mexico.

**Table 8. Soybean Export over-pricing**

Year	Soybean meal	Soybean oil	Soybean	TOTAL
2010	21.182.572	2.336.356	43.365	23.562.293
2011	32.390.020	12.470.257	44.528.967	89.389.244
2012	42.196.592	24.541.622	8.603.375	75.341.589
2013	66.439.464	2.041.905	5.372.137	73.853.506
2010	0%	0%	0%	0%
2011	0%	0%	2%	1%
2012	1%	1%	1%	1%
2013	1%	0%	0%	1%

Source: Reuters and Penta Transaction

It should be noted that this methodology does not allow for a complete analysis of the impact of the use of intermediaries for profit shifting in commodity exports.<sup>32</sup> Similarly, this analysis does not shed light on illicit financial flows channelled through other transfer pricing mechanisms, such as financial transactions, payments for intangibles or services, and the import of goods. Moreover, estimates of the manipulation of intragroup prices are likely to be higher where these distinct transfer pricing mechanisms can be identified and incorporated in analysis.

While this analysis does not differentiate between exports to related and non-related parties, based on the levels of concentration

<sup>32</sup> This has been attempted in Cobham, Jansky, and Prats (2014).

and integration in this sector, it should be assumed that there is either an economic linkage between parties or the possibility of applying trade mispricing mechanisms as if such a linkage existed.<sup>33</sup>

## V. CONCLUSIONS AND RECOMMENDATIONS

Many developing countries are particularly concerned with problems of transfer pricing in the extractive industries, which are often significant components of their economies. Similar to other sectors, profit attribution may be highly dependent on the valuation of commodity exports. For this reason, a number of developing countries have adopted the “Sixth Method”, following the Argentine experience. This method aims to establish a clear and easily administered benchmark and avoid the need for subjective judgment and discretion (BMG, 2015a).

However, even when the application of the Sixth Method is legislated for, and given Argentina’s extended experience dealing with commodity mis-invoicing, the data shows that such practices are still being employed by multinational companies, resulting in under-invoicing by approximately 10% in the Argentine soybean and soybean related products export sector.

One of the difficulties evidenced for the application of the Sixth Method is the limitation imposed when its application is limited to cases in which the intermediary is understood to have no economic substance. The economic substance of the intermediary is in most cases almost impossible to prove, and as has been observed in the Argentine case, companies have found ways in which to provide the intermediary with substance and avoid the application of the Sixth Method.

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<sup>33</sup> Argibay Molina (2013, pp. 82-84) presents the case of over-invoicing of transport costs, which requires for it to be possible that the exporter has a related party located in a jurisdiction that could, for example, be the Netherlands, that acts as an intermediary for the transport transactions. The company actually rendering the transport service does not need to be related. What happens in practice is that the exporter pays its related party for the transport service, and this intermediary pays the actual non-related service provider but keeps a margin for itself. In this way, the transport is over-invoiced, but the actual non-related service provider is paid at a market price. The intermediary may later transfer such margin to another related party in a tax haven or secrecy jurisdiction.

Nevertheless, Argentine court cases show that it has been found to be a reliable tool to settle transfer pricing disputes, regardless of whether it is considered a benchmark of the CUP Method or a separate method for the valuation of commodities; and regardless whether an analysis of the economic substance of the intermediary is made.

However, there are some major variations in the way in which the Sixth Method has been applied in different legislations that need to be highlighted, and their impacts followed upon. Such differences relate to, among other things: a) the consideration of the Sixth Method as an independent method for valuation, or as a variation of the CUP method; b) the date of the quote to be used (e.g. shipping date, delivery date, unloading date, average prices, the price at the date of the agreement, etc.); c) the value given to the written arrangement between the parties and; d) the range of comparability adjustments accepted.

Some of these variations seem to correspond to the pressure exercised by the transnational conglomerates trading commodities as well as their tax and legal advisors that in many countries advise both the multinational enterprises and tax administrations. In this sense, the written arrangements between the parties have proved to have little value in some Argentine court cases, something that seems logical considering that related parties do not establish “contracts” in equal negotiating conditions; and the date of the quote to be used has also been found to be the object of manipulation in order to leave the maximum profit in the most convenient jurisdiction for tax purposes.

Therefore, even when the Sixth Method seems to be a useful tool for tax authorities in countries exporting commodities, it could prove useful in time to do an analysis of court cases at an international level, and to analyse as well the impact of its application on the tax authorities’ revenue collection, in order to better understand the way in which the different variations of the Sixth Method have proved to be a solution or a problem for the determination of the taxable profit in commodity trading cases.

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## **APPENDIX 1. COURT CASES IN ARGENTINA RELATING TO THE APPLICATION OF THE IMPORT-EXPORT CLAUSE OR THE SIXTH METHOD<sup>34</sup>**

All court cases relating to the application of the Sixth Method for the valuation of commodities or the import-export clause have been listed in this section. There is no public list of such cases, so the list is as exhaustive as it can be.

**SIA S.A. (CSJN ruling from 1967)** declared losses on the export of horses to Peru, Venezuela and the United States of America. The Tax Authority at that time (Dirección General Impositiva - DGI) challenged this under the export and import clause and calculated the “wholesale price” based on data from foreign magazines on the horse business, which explicitly referred to the horses of the taxpayer and the transactions involved in this case.

From 2003 onwards, the Administración Federal de Ingresos Públicos (AFIP; in English, Federal Administration of Public Revenue) attempted to apply the Sixth Method in several cases that reached different court levels. However it did not always succeed in this application because all such cases related to fiscal years prior to the method’s introduction into Article 15 (2003), and so the AFIP’s attempts faced the problem that legislative changes can only be applied prospectively.

**Volkswagen (fiscal year 1998, Tribunal Fiscal de la Nación (TFN) ruling from 2009):** A company resident in Brazil acquired products from Volkswagen Argentina S.A., and sold them to Volkswagen do Brasil. The AFIP considered that the three were related parties, and that the import-export clause should be applied and the prices compared with the wholesale price in the jurisdiction of destination, and if such prices were not found, the wholesale price in the seller’s jurisdiction, which in this case would be the price of the local car dealers. The tax authority had found that the export prices for cars sold to Volkswagen do Brasil were significantly lower than those in the local market, and therefore understood that the local market price should be taken as valid. However, the court rejected

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<sup>34</sup> This section contains significant extracts from Grondona and Knobel (2017). For a complete list of Argentine court cases on transfer pricing, see Grondona and Knobel (2017).

this possibility, as it considered that the wholesale price in the country of destination should have been used for the comparison.

**Cargill S.A.C.E.I. (ruling of 2011 by the Cámara Nacional de Apelaciones en lo Penal Tributario - CNAPT, National Appeal Court for Tax Crimes; relating to fiscal years 2000-2003):** The case related to exports from Argentina through a branch located in Uruguay. The company argued that the prices from Montevideo were settled with different importers throughout the world and that these prices were agreed verbally by telephone or through different types of mail, in relation to the demand and supply at the date of these communications, and that this is the reason why the prices were different from those at the shipping date taken by the tax authority. Cargill's directors were charged for the crime of tax evasion, and the Court on Economic Crimes ruled against them on the grounds that there was no definitive date of agreement; but on appeal to the CNAPT that court ruled in their favour, considering that the pricing methodology involved had not always resulted in a lower export price.

**Nidera S.A. (ruling by TFN ratified by the Camara Contencioso Administrativo Federal (CCAF) in 2013 and revoked partially by the CSJN in 2016;<sup>35</sup> relating to fiscal year 1999):** Nidera S.A. exported commodities (cereals and oils) through intermediaries resident in tax havens, and argued that its export prices were based on the export prices at the date of the agreement. The case discussed whether the Sixth Method, the import-export clause (*Ley de Impuesto a las Ganancias -LIG-*, in Spanish), or the Comparable Uncontrolled Price (CUP) Method should have been applied. The tax authority finally stipulated the use of the CUP Method (Article 15 of the LIG) based on prices published by the Secretary of Agriculture in Argentina at the shipping date and corresponding to an analysis of the behaviour of other comparable companies (Alfred C. Toepfer and La Plata Cereal S.A.). The TFN ruled in favour of the tax authority and the CCAF upheld the decision of the TFN. However, in 2016, the CSJN asked the CCAF to review its first ruling.

<sup>35</sup> See <https://www.adelaprat.com/2017/02/impuesto-a-las-ganancias-exportacion-a-entidad-radicada-en-paraiso-fiscal-la-csjn-revoca-aspecto-de-la-sentencia-que-invoca-incorrectamente-el-principio-de-valor-de-mercado-abierto-y-solo-para-las-ope/>.

**Oleaginosa Moreno S.A.C.I.F.I.A. (ruling by TFN of 2014; relating to fiscal year 1999):** Oleaginosa Moreno exported commodities to Atlantic Oils & Meals (a related party resident in Switzerland), priced free on board (FOB), at international prices on the contract date. The invoice date was relatively close to the shipping date, but the price reflected in the invoice was based on a prior contract, which did not have a specific date. In the transfer pricing documentation presented by the taxpayer, Deloitte used the CUP method to validate Oleaginosa Moreno’s prices, comparing the company’s averaged prices with the ones published by the Secretary of Agriculture for the invoice date. The tax authority made the tax adjustments based on the highest price (referring to Article 8 of the LIG, although it did not use the prices at destination and nor did the taxpayer) published by the Secretary of Agriculture between the invoice and the shipping date for the commodities exported to Atlantic Oils & Meals, in a transaction by transaction analysis. The tax authority also observed that the exports made to an independent party in Chile had been priced using the quotes published by the Secretary of Agriculture for the invoice date. The adjustments made by the tax authority reduced the tax loss carry forward of the taxpayer. The taxpayer questioned the use of the shipping date, alleging that the Sixth Method had been applied retroactively; and it objected to the internal comparables (the transactions with the independent party in Chile) used, alleging that the transactions had significant differences for which no adjustments had been made. The TFN found that there had not been a retroactive application of the Sixth Method. However, it ruled in favour of the taxpayer since the legislation in place in the fiscal year under analysis did not indicate that the price to be used should be that of the international exchange quoted price at the shipping date, so a valid quoted price at the date for the contract could be used. The TFN also observed that the transactions with the independent party in Chile could not be used as a reference for the date to be used due to the significant differences they had with the transactions with related parties. Nevertheless, the TFN ruled in favour of the tax authority in relation to the use of a transaction by transaction analysis, instead of the average global analysis employed by the taxpayer.

**Oleaginosa Moreno S.A.C.I.F.I.A. (ruling by CSJN of 2014 relating to fiscal year 2000):** The AFIP objected to the export price of commodities sold to Atlantic Oils & Meals, a related party located in Switzerland,

because for 36 transactions the price had been documented as an average instead of individually. The AFIP proposed that such prices should be calculated individually and in relation to the price at the shipping date. The TFN partially confirmed the AFIP's position, observing that the legislation in place was consistent with the methodology chosen by the AFIP, although the use of the contract date could also be permitted – as suggested by the company – since the legislation in place at the time of the operations did not indicate the use of any specific date. The AFIP had also observed a difference between the price paid for the export of commodities to related parties and to independent parties located in Chile. However, the TFN accepted the complaint of the company observing that there were differences in the conditions of these transactions that precluded such transactions from being used as internal comparables. Both the AFIP and Oleaginosa Moreno appealed to the CCAF, which ruled in favour of Oleaginosa Moreno, and the AFIP's further appeal to the CSJN was also rejected.

**Alfred C. Toepfer Internacional (ruling by CCAF of 2016 relating to fiscal year 1999)** had been selling commodities to its related parties through traders resident in tax havens. The Tax Authority argued that the Sixth Method was applicable. The TFN and CCAF initially ruled in favour of the Tax Authority, but Toepfer appealed to the CSJN and the CSJN requested the CCAF to review its ruling in 2015. In 2016, the CCAF issued a revised ruling in which it gathered information on all exports of the fiscal year 1999 and determined that 50% had been made to related parties in which (i) the country of destination of the merchandises was different than the country where the client was located; (ii) there was no reference in the contracts to the value at the shipping date that could help explain the differences in prices; (iii) some sales were made on purchases made at a date later at a higher price of goods that were in transit; (iv) some suppliers from abroad sold merchandise that was of Argentine production; (v) various suppliers and intermediaries were located in tax havens. Regarding the use of the price at the shipping date, the CCAF considered that this was consistent with the CUP method, as it had been argued by Toepfer that the Tax Authority had made a retroactive application of the Sixth Method.<sup>36</sup>

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<sup>36</sup> See [www.cronista.com/fiscal/Comentario-del-fallo-de-precios-de-transferencia-por-exportaciones-realizadas-entre-empresas-vinculadas-20170814-0010.html](http://www.cronista.com/fiscal/Comentario-del-fallo-de-precios-de-transferencia-por-exportaciones-realizadas-entre-empresas-vinculadas-20170814-0010.html).

# **CHAPTER 5**

## **IMPROVING TRANSFER PRICING AUDIT CHALLENGES IN AFRICA THROUGH MODERN LEGISLATION AND REGULATIONS<sup>1</sup>**

Thulani Shongwe

### **I. INTRODUCTION**

African countries, like the rest of the world, form part of the global community. This global community is constantly evolving and innovating with new trends and technologies introduced at a very rapid rate. It is without saying, that the global community's evolution is spearheaded by businesses and a consumer appetite to make things easier and more convenient. The conundrum this has made for the relationship between businesses and the state is tense, due to the calls to collect more revenue while encouraging foreign direct investment (FDI).

As such, the structuring of companies takes into account the most efficient and most cost-reducing methods to ensure profit maximisation but equally wealth maximisation. No truer is this scenario than on the African continent, where resources are plentiful across its 54 countries. Whilst transfer pricing (TP) is legal and necessary, it can be abused by Multinational Enterprises (MNEs) to shift profits and avoid tax liability in African countries.

When members of multinational groups of companies undertake transactions with each other, such as buying and selling goods and services, one member of the MNE charges a price to another member (i.e. the "transfer price"), which is reflected in their accounts and forms the basis for the computation of their accounting and taxable profits. The transfer prices used by MNEs influence a number of profits that they report (and

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 8 (July 2019).

pay tax on) in each country in which they operate. An example of a transfer pricing transaction between companies belonging to the same MNE and operating in three different jurisdictions is illustrated below.

This method of conducting business across multiple jurisdictions requires capacity, both in the business but possibly more in revenue administration. The latter requires a large amount of audit capacity based on the number of companies present either through a permanent establishment (PE) or through a subsidiary in the country. The auditing of a multinational is a process that needs to be followed carefully as, ultimately, the multinationals are taxpayers and contributors to other taxes in the fiscus and, therefore, play a significant role in the economies of some countries. This is highlighted in the findings from a report by the Organisation for Economic Co-operation and Development (OECD), where Rwanda reported that 70% of its tax base comes from MNEs and in Burundi, one company contributes nearly 20% of total tax collection. Lastly, Nigeria, which is the largest economy in Africa, reported that MNEs represent 88% of the tax base.<sup>2</sup>

It is in this light that African countries should identify transfer pricing risk, as well as have sufficient transfer pricing audit capacity. Skill development and risk identification have become topical issues for African countries as revenue administrations are still undergoing various forms of transformation at various levels including taxpayer segmentation.

This chapter will look at two factors that are essential in collecting revenue in an already under-capacitated environment. The first aspect is determining the amount of capacity building and training conducted for auditors working on transfer pricing by focusing on the audit processes, questions and fact-finding; this is discussed in the next section. Thereafter, the chapter will look at the hurdles some audit processes experience due to ineffective legislation and regulations. This section will offer some solutions that have been

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<sup>2</sup> OECD, *Report to G20 Development Working Group on the impact of BEPS in low income countries, Part 1* (July 2014), p. 11. Available from [www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf](http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf).



proposed in innovative legislation and regulations. The primary aim of improving legislation is of course to increase revenues collected, but at the same time, countries are committed to implementing Agenda 2063 and the Sustainable Development Goals (SDGs).

## **II. INCREASING COMPLIANCE AND BUILDING A POSITIVE RELATIONSHIP BETWEEN TAX ADMINISTRATION AND TAXPAYERS**

Challenges for African countries are generally classed under capacity. While this may sound like a broad and wide problem, this chapter will look at one specific area which has challenged the capacity of auditors to achieve their targets effectively. The African Tax Administration Forum (ATAF) is carrying out “Country Programmes in Transfer Pricing” to improve audit capacity and provide advice and direction on the drafting of new legislation and regulations.<sup>3</sup> The aim of these programmes is to ensure that an audit is well equipped and has the legislative tools it needs to effectively identify transfer pricing risks and audit those risks efficiently and effectively.

The availability of legislative standards poses a unique opportunity to face off with aggressive taxpayers, leading to an aggressive audit process. The lack of clear and effective legislation and of the necessary audit skills can lead to a confrontational approach to the audit for both the tax administration and the taxpayer, which does not achieve any positive gains for either party. The aim of innovative regulations is to encourage compliance while attracting investment.<sup>4</sup> The compliance model is an essential aspect of revenue administrations, and African administrations are working to develop compliance risk models. The Tax Administration Diagnostic Assessment Tool (TADAT) Performance Indicator 2 is at the core of the design of the interaction with taxpayers. In the same TADAT assessment, 4 African countries

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<sup>3</sup> ATAF, Cross Border Taxation Country Programmes Marketing Brochure (2016), p. 3.

<sup>4</sup> United Nations Third International Conference on Financing for Development (13 July 2015), *ATAF Side Event – The African Agenda 2063: Finding the Money! – Developing African Tax Systems in Order to Mobilise Domestic Resources to Fund Africa’s Development*, Briefing Document, p. 2.

have scored low levels.<sup>5</sup> This is not a direct reflection on the transfer pricing compliance levels. However, noting that African countries, as highlighted above, rely on MNEs and corporate income tax (CIT), it is worth considering how compliance can be improved. In its rollout of technical assistance interventions, ATAF has established that much of the compliance challenges in transfer pricing can be overcome by simplifying legislation and regulations. To this end, ATAF has developed the “Suggested Approach to Drafting Transfer Pricing Legislation”, which is a guide for developing countries on how to develop appropriate legislation and regulations in the post-Base Erosion and Profit Shifting (BEPS) world.

African countries have adopted various approaches to collecting information from taxpayers on their transfer pricing practices. The most commonly used are obligations to submit a transfer pricing schedule. This ideally should be submitted together with the annual tax return and transfer pricing documentation should be prepared and maintained (with penalties imposed for inadequate documentation). However, as illustrated in this chapter, many countries do not have strong documentation requirements. Those that do have impose a penalty in line with international best practices. The disclosure requirements also play an important role in raising awareness and promoting taxpayers’ compliance with the transfer pricing rules.

In order to illustrate the positive effect that modern legislation can have on compliance, one can look at the case of South Africa. The changes in the South African Income Tax Act Section 31 on international taxation (which deals with transfer pricing) is one such case. A recent GIZ (Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH) paper makes the link that the new law in South Africa had a positive increase in the collection for the State.<sup>6</sup> The South African Revenue Service (SARS) noted that TP posed a major compliance risk and therefore set in motion a change of regulation to increase compliance and generate revenue. Under these

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<sup>5</sup> TADAT Secretariat. Available from [www.tadat.org](http://www.tadat.org).

<sup>6</sup> Joshua Stadler, “Fighting Illicit Financial Flows - How Tightening South Africa’s Transfer Pricing Rules Has Increased Tax Revenues”, GIZ Discussion Paper (2016), p. 2.

new TP rules, SARS has been able to combat BEPS tax avoidance more effectively.

This chapter will look at some of those key aspects of the modern TP legislation and additionally illustrate how different drafting of regulations can assist in additional revenue collection as well as increased compliance. Use of practical examples from real cases, which have been adapted to conform with secrecy provisions of each tax jurisdiction will illustrate where poor legislation has given rise to tax planning and to profit shifting. Lastly, the chapter will offer practical solutions to some of the transactions illustrated through the ATAF Suggested Approach to Drafting Transfer Pricing Legislation. This is a practical tool that has been developed by the ATAF Secretariat and the members of the ATAF Cross Border Taxation (CBT) Technical Committee.<sup>7</sup>

### **III. AUDITING A MULTINATIONAL IS A DIFFERENT BALL GAME**

A general auditor in a revenue administration would be tasked with overseeing all taxes such as value added tax (VAT), pay as you earn (PAYE), corporate income tax (CIT) etc. After assessing the various tax risks, the auditor can easily flag it for additional support such as in transfer pricing. This is assuming that the auditor looking at the taxpayer can spot a transfer pricing transaction.

Auditing MNEs often involves a broad range of complex technical issues. Transfer pricing is often the most important one and is the focus of this chapter. However, linked to transfer pricing is the need to analyse other technical issues such as permanent establishments, treaty abuse – including withholding tax issues, and “treaty shopping”. Excessive interest deductions by MNE taxpayers are often a significant risk to the tax base, leading to discussions on thin capitalisation and the introduction of legislative measures to counter excessive interest deductions. Lastly, international tax planning using, for example, hybrid instruments and entities also poses significant risk to the tax base. These kinds of risk have also been noted

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<sup>7</sup> The CBT Technical Committee consists of 9 countries, namely, Botswana, Burkina Faso, Ghana, Kenya, Nigeria, Senegal, South Africa, Tanzania and Uganda.

in the BEPS Actions 2 and 4 as African countries still largely use debt to equity rules which are generally reported to be largely ineffective and easy to circumvent.

Taking into account the significant resources available to multinationals, including access to advice from auditing firms, it is prudent that auditors at revenue administration take into account a number of key factors. The auditing of MNEs is not simple and requires careful considerations to be made. At the core of it, there has to be a clear understanding of how the business is organised. This includes understanding the commercial and economic reality of business operations such as the generation of incomes, profits and which functions of the business are essential to generating the profits.

Issues in an MNE audit may include:

- Understanding how businesses are organised and how they function;
- Transfer pricing concepts such as “risk”;
- Understanding benchmarking exercises for transfer pricing comparability analyses;
- Valuation of assets (e.g. plant, share disposals);
- Profit shifting through transfer pricing and interest deductions;
- Other international issues: residence, permanent establishments, treaty issues;
- Mismatch instruments;
- Accounting treatment.

Auditing MNEs rarely involves:

- Checking figures in accounts against books and records.

Auditing MNEs needs careful administration, including:

- Selection of right cases - As issues are often complex and tax administration resources to deal with these issues are often limited;
- The consistent approach, in line with domestic law and international principles;
- Closing cases when appropriate – This requires an effective and

- robust governance process;
- Settling cases appropriately – Once more, this is where an effective and robust governance process is required;
- Taking the right cases into the judicial processes;
- Ensuring the right skills are available and used;
- Ensuring treaty provisions are correctly administered: mutual agreement procedure (MAP), advance pricing agreements (APA), corresponding adjustments, exchange of information;
- Encouraging good communication with taxpayers to encourage voluntary compliance.<sup>8</sup>

#### **IV. APPROACHES AVAILABLE TO TAX ADMINISTRATIONS FOR TP AUDITS**

This section will briefly discuss the possible approaches tax administrations might take to address the above issues. Recently, in the technical assistance and in-country interventions carried out by ATAF, auditors are being introduced to the ATAF Risk Assessment Tool for Transfer Pricing. This is coupled with the training of auditors on how to compile their audit cases as well as the setting up of “Settlement Committees” for the closing of audit cases. It is worth noting that every transfer pricing case is unique and each country and its audit teams will have to exercise their own discretion on the validity of the process to follow.

Therefore, case selection is probably the most important aspect of transfer pricing, and this has to be based on a number of factors.<sup>9</sup> As highlighted above, ATAF member countries currently engaged in transfer pricing country programmes are using risk assessment methods to improve their case selection.

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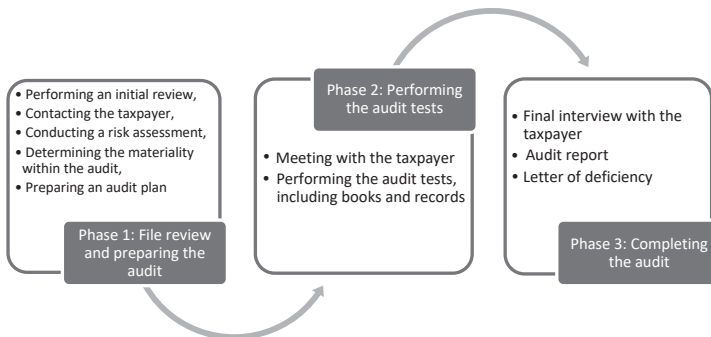
<sup>8</sup> These steps are part of the ATAF Training Manual used for the training of auditors in detecting transfer pricing transactions and risk. The training schedule is applied in all the ATAF Country Programmes on TP. The Country Programmes are typically 3 years long and work to develop the core skills of auditors while addressing policy issues such as redrafting of legislation and regulations.

<sup>9</sup> OECD, “Selecting the right cases”, in *Dealing Effectively with the Challenges of Transfer Pricing* (Paris, OECD Publishing, 2012). Available from [https://www.oecd-ilibrary.org/taxation/dealing-effectively-with-the-challenges-of-transfer-pricing\\_9789264169463-en](https://www.oecd-ilibrary.org/taxation/dealing-effectively-with-the-challenges-of-transfer-pricing_9789264169463-en).

Below is an example of risk factors to be considered when selecting a case for transfer pricing audit:

- Significant transactions with related parties in low tax jurisdictions;
- Transfers of intangibles to related parties;
- Business restructurings;
- Specific types of payments;
- Loss-making including Year on Year loss-making;
- Poor results;
- Effective Tax Rate;
- Poor/Non-existent documentation;
- Excessive debt;<sup>10</sup>

### **Audit Process outline**



Source: ATAF & OECD Training on auditing MNEs, Burundi, 2013

## **V. THE CHALLENGES OF AUDITING COMMODITY TRANSACTIONS**

African countries face challenges when dealing with transfer prices. These can be summed up as follows:

- Weak legislation;

<sup>10</sup> ATAF Transfer Pricing Risk Assessment Tool

- Limited tax administration capacity; and
- Limited access to information.

Commodities form a large base of many African countries' gross domestic product (GDP) and revenue. The industry though provides complexities that challenge revenue administrations in collecting revenue, particularly in auditing. With a large range of commodities across many jurisdictions, each commodity has cost components. These cost breakups provide a starting point for a tax administration to consider potential issues that may arise in transfer pricing auditing as they carry activities of related transactions that may be of financial importance of different types of mines for different commodities.<sup>11</sup>

Africa has a great number of minerals, including precious metals and stones. In Nigeria alone, there are about 62 different types of minerals spread across the country. However, due to the recent reforms in the sector, eight strategic minerals have been identified by the Nigerian Ministry of Mines and Steel Development as economically viable and the most promising solid mineral assets that exist in commercial quantities in the country.<sup>12</sup>

The starting point in understanding the magnitude of the issues faced by tax administrations is the tax risk of undervaluing the exports and difficulties in pricing due to routing through related party marketing hubs. A prime example of this was seen last year in the Australian Tax Office (ATO) assessment of BHP Billiton Australia. The ATO claimed that BHP avoided its tax obligations by funnelling some of the profits made from mining Australian commodities and selling them to a Singaporean company. Essentially, the dispute is the price at which BHP sold these commodities to the company in Singapore before these

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<sup>11</sup> Pietro Guj, Stephanie Martin and Alexandra Readhead, "Transfer pricing in mining with a focus on Africa: a briefing note (English)" (Washington D.C., World Bank Group, 2017) p. 99. Available from <http://documents.worldbank.org/curated/en/213881485941701316/Transfer-pricing-in-mining-with-a-focus-on-Africa-a-briefing-note>.

<sup>12</sup> Presentation by Mr. Ajayi Bamidele, Coordinating Director, Domestic Taxes, Federal Inland Revenue Service of Nigeria at the ATAF Experts Meeting on extractives, April 2016 in Johannesburg, South Africa.

were then sold off to the final customer in Asia.<sup>13</sup> An example of this follows later in the chapter, where legislation and regulations can assist in the pricing of such commodities.

Additionally, MNEs also use profit stripping through interest, royalty and technical fee payments to related parties. Recognising that some MNEs are highly leveraged with third party debt for non-tax reasons, tax administrations need to consider various options to ensure profit stripping does not take place.

An example of this is inter-company debt – the subsidiary receives debt from a parent or an affiliated company, often a corporate treasury located in a low tax jurisdiction, to finance geological exploration or mine development. Debt generates interest payments, which are tax deductible. Most African countries currently limit the maximum amount of debt on which deductible interest payments are available, by way of a debt-to-equity ratio. However, the cost of related party debt (i.e. interest rate) is difficult for tax authorities to price, leaving the tax base vulnerable to excessive interest deductions.

Moreover, commodities tend to prove complex for developing countries as some countries have a variety of commodities exploited by a number of mining companies. Therefore, the capacity of the tax administration requires sufficient resources to identify transfer pricing and risks thereof.

## **VI. NEW LEGISLATION AND REGULATIONS: A NEW BALL GAME**

In 2010 the National Treasury and SARS identified transfer pricing as one of its main areas of tax loss risk and made extensive reforms to its transfer pricing legislation to address those risks. The changes to South Africa's legislation became effective from 1 April 2012 and resulted in additional revenues for South Africa amounting to ZAR 29 billion. Interestingly, this additional revenue was not due to increased audit activity but rather due to the certainty and clarity of the tax law.<sup>14</sup> Therefore, the need for

<sup>13</sup> Jamie Smyth, "BHP to contest A\$1bn Australia tax bill", *Financial Times*, 21 September 2016. Available from [www.ft.com/content/a90c4ce8-7f99-11e6-8e50-8ec15fb462f4](http://www.ft.com/content/a90c4ce8-7f99-11e6-8e50-8ec15fb462f4).

<sup>14</sup> Stadler, *Fighting Illicit Financial Flows*, p. 4.



new and modern legislation and regulations is a path that every African country should take where there are capacity challenges in audit and tax administration in general.

During the recent work done by ATAF to assist many of its members to build more effective transfer pricing regimes, the ATAF International Tax team identified similar deficiencies in current transfer pricing legislation in Africa to those faced by South Africa prior to the 2012 changes.<sup>15</sup>

African countries have traditionally either not updated their laws or have narrow definitions in their laws that allow MNEs to structure transactions either with aggressive transfer pricing mechanism or through excessive debt structuring to shift profits to low tax jurisdictions.<sup>16</sup> This is further compounded by the narrow wording on the treatment of commodity transactions provided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations prior to their latest release in July 2017. It is therefore prudent to review the types of wording that have given the opportunity for aggressive transfer pricing and have resulted in tax losses for African countries.

### **Why is there a need for changing legislation and regulation?**

As the global tax agenda has shifted significantly in the last few years, it is essential for African countries to take note that outdated legislation leaves them at risk. In illustrating the need for modern legislation, below is a table that shows how old rules and new rules are essential in dealing with various transactions.

In many African countries, primary rules on transfer pricing lack clarity and risk being ineffective in addressing complex transfer pricing arrangements. Where this exists, it gives rise to tax planning and further creates an unfavourable investment climate. Lastly, this then gives the immediate challenge to tax administrations to enforce the transfer pricing rules, and it is difficult for auditors to deal with transfer pricing cases effectively. Some Economic Community of

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<sup>15</sup> ATAF Workshop on Transfer Pricing Regimes in Africa (Nairobi, Kenya, 27-28 July 2016), Outcomes Statement.

<sup>16</sup> Guj, Martin and Readhead, "Transfer pricing in mining with a focus on Africa", p. 94.

West African States (ECOWAS) countries have adopted a definition of “related party” that has the potential to either not deem a relationship to be related in circumstances that pose a transfer pricing risk, or deem a relationship in circumstances where there is little or no real risk.<sup>17</sup> Once more, this is a clear illustration of where redrafting of rules is required.

<b>Old Rules</b>	<b>New Rules</b>	<b>Reason for change</b>
Each transaction was looked at in isolation from the other transactions between the connected parties	Focus on the overall arrangement between connected parties so that all the transactions between the connected parties can be considered holistically	The old rule was too narrow; it required each transaction to be looked at separately, which meant more complex arrangements involving a series of transactions were not caught
Emphasis on the price of the transaction	Emphasis on all the terms and conditions of the transaction	Focusing only on the price of a transaction creates opportunities for abusive transfer pricing by taxpayers adding terms and conditions to the transaction that would not occur at arm’s length resulting in profit shifting through inappropriate pricing
The onus of proof with the tax administration	The onus of proof with the taxpayer	Taxpayers should be required to return on an arm’s length basis and provide evidence that the pricing is arm’s length

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<sup>17</sup> Ibid.

No or limited requirement for taxpayers to keep transfer pricing documentation	The legal requirement for taxpayers to keep transfer pricing documentation	As set out in international standards taxpayers should keep adequate documentation to demonstrate that transfer pricing of transactions between connected parties is arm's length
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Source: ATAF and Joshua Stadler

## **VII. PRICING COMMODITIES AND THE CHALLENGES FACED BY AUDITORS**

During the second year of the BEPS Project, the ATAF was invited to observe the Committee for Fiscal Affairs (CFA). Through this, ATAF was also invited to participate in the working party meetings. Of particular interest to this chapter is Working Party 6 (WP6) which deals with the Taxation of Multinational Enterprises. The ATAF interaction with the OECD Secretariat, OECD member countries, Group of Twenty (G20) countries and other invited observers was regarding the minimal content attached to the pricing of commodities for transfer pricing purposes. Therefore, some wording proposals were put forward to ensure that African countries benefit from the guidelines' interpretation of commodities.

To provide protection against base erosion from the under-valuation of commodity exports, WP6 proposes to revise the OECD Transfer Pricing Guidelines (TPG) on the transfer pricing of commodities.

Many ATAF members report that commodity exports are very significant to the economies of many African countries and the potential loss of tax to African countries where those commodities are exported to another company in the MNE group at undervalue is a major risk to their tax base.<sup>18</sup>

<sup>18</sup> ATAF Secretariat, Report of the 4th Meeting of the CBT Technical Committee (Nairobi, Kenya, 28-29 July 2015), p. 6.

At the WP6 meeting in May 2017, the ATAF working closely with the OECD Secretariat and other interested countries was successful in getting WP6 agreement to a revised draft which will assist ATAF members and other commodity-rich countries to address the risk of commodity exports being underpriced. This revised guidance will assist ATAF members in the introduction of domestic legislation, as such legislation will be aligned with international standards.

The challenge faced by many African tax administrations in relation to commodity pricing is the information asymmetry between the tax administration and the taxpayer, particularly in respect of information held outside the tax administration's jurisdiction. This is further exacerbated by the fact that there are few treaties in African countries. The table below illustrates a number of treaties in African countries.

<i>Country</i>	<b>Number of Treaties</b>
<b>Egypt</b>	<b>55</b>
<b>Kenya</b>	<b>8</b>
<b>Nigeria</b>	<b>12</b>
<b>Senegal</b>	<b>More than 10</b>
<b>South Africa</b>	<b>92</b>

Source: ATAF

The identified challenges to African countries can be summed up as follows:

- Adjustments to the quoted price or the charging of high fees to the taxpayer in the commodity producing country by other group companies in the supply chain (e.g. processing, transportation, distribution, marketing); and,
- Supply chain entities which do not have much of a function and in many instances are located in low tax jurisdictions.

For the second point, many African countries have serious concerns that the interposition of such entities in the supply chain represents a major risk to their tax base and they encounter significant challenges in effectively addressing these risks.

In addressing the issue of information challenges, the Guidance now proposes that, in respect of the difficulties in obtaining the necessary information to establish the pricing date, tax administrations, in certain circumstances, may be able to deem the pricing date. This will be illustrated in a later example.

## **VIII. NEW LEGISLATION FOR COMMODITIES**

Through participation in the OECD/G20 BEPS Project, ATAF was able to achieve the rewriting of Chapter II of the OECD Guidelines for Transfer Pricing under the section on commodities. This was primarily done due to the lack of guidance from the previous editions of the Guidelines, but also as a means of highlighting the abuse that happens in the sector.

Chapter II of the Transfer Pricing Guidelines has been amended to include new guidance especially applicable to commodity transactions.<sup>19</sup> At the core of the changes is a new provision on the determination of the pricing date for commodity transactions. This provision should prevent taxpayers from using pricing dates in contracts that enable the adoption of the most advantageous quoted price. It allows tax authorities to impute, under certain conditions, the shipment date (or any other date for which evidence is available) as the pricing date for the commodity transaction.

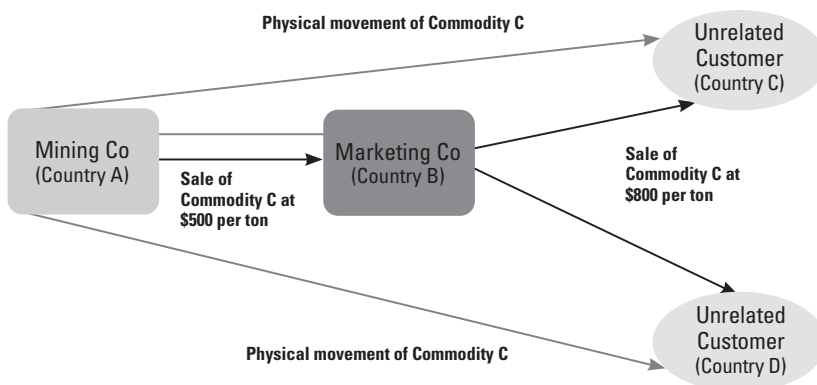
When assessing the transaction, the guidelines provide for the following:

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<sup>19</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Final Reports, Actions 8 – 10 of the BEPS Project*, OECD/G20 Base Erosion and Profit Shifting Project (Paris, OECD Publishing, 2015). Available from [https://www.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports\\_9789264241244-en](https://www.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en).

- The Controlled Unrelated Party (CUP) method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises;
- Quoted prices can be used under the CUP method, subject to a number of considerations, as a reference to determine the arm's length price for the controlled commodity transaction; and
- Reasonably accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.<sup>20</sup>

### Example 1 - A marketing hub transaction with illustration



**Marketing arrangements** – A related company, for example, a marketing hub, buys mineral products from the mine. The key issue is whether the mineral products are transferred to a fully-fledged related party marketer that takes ownership of the product, performs value-adding functions and assumes entrepreneurial risk, or, more commonly, a hub that merely provides a support function.

Such a hub imposes a risk to revenue: marketing arrangements and intercompany debt are of significance; even 1 per cent of these

<sup>20</sup> Ibid.

transactions are likely to be a big amount for developing country revenues. For example, BHP Billiton is currently in a dispute with the Australian Tax Office (ATO) over a USD 755 million tax bill relating to its use of a marketing hub based in Singapore to sell commodities to Asia.<sup>21</sup>

**How does the new rule “catch” the marketing hub?** – It is the quoted price provision that addresses the marketing hub issue as it gives none of the value of the exported commodity to the hub unless the taxpayer provides all the evidence that at arm’s length it should retain part of the value. This addresses the information asymmetry issue between taxpayers and tax administrations.

#### **ATAF Recommendation:**

*[W]here a resident person engages directly or indirectly in a transaction with a connected person or a non-resident person engages directly or indirectly in a transaction relating to a permanent establishment in [Country] with a connected person for the export or import, involving . . . goods where prices can be obtained at the date of the transaction from an international or domestic commodity exchange market, or from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, or from any other index that is used as a reference by unrelated parties . . . that quoted price on the date on which the goods are shipped . . . shall be, without considering the price that was agreed upon with the connected person, the sale price used for the purposes of computing the taxable income of that person unless the person provides all of the evidence needed to show that adjustments are appropriate to that quoted price to be consistent with the arm’s length principle.*<sup>22</sup>

#### **Example 2 - Shifting the burden of proof**

The combination of shifting the burden of proof from the tax administration to the taxpayer and the TP Documentation Regulations can provide tax administrations with the information they need to test the taxpayer’s pricing. For example, the Documentation rules require

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<sup>21</sup> Jamie Smyth, “BHP to contest A\$1bn Australia tax bill”, *Financial Times*, 21 September 2016. Available from [www.ft.com/content/a90c4ce8-7f99-11e6-8e50-8ec15fb462f4](http://www.ft.com/content/a90c4ce8-7f99-11e6-8e50-8ec15fb462f4).

<sup>22</sup> ATAF, *Suggested Approach to Drafting Transfer Pricing Legislation*, p. 2

details of comparables used and why they were used. If there is no rule, then the taxpayer can simply assert that the price is arm's length with no legal requirement to evidence it or to have to prove that it is arm's length, as the burden to show that the actual price is not arm's length falls on the tax administration.

**ATAF Recommendation:**

*Paragraph 9: Every person who engages in a transaction to which subsection (1) applies shall keep the documentation required under [Insert Transfer Pricing Documentation Regulation reference].<sup>23</sup>*

This is included in the primary legislation, thereby making it an essential part of the reform of legislation in a country. The recommendations have an entire approach to the drafting of Documentation Regulations.

**ATAF Recommendation:**

**Proposed Transfer Pricing Documentation Regulation**

- 1. These Regulations may be cited as the Income Tax (Transfer Pricing Documentation) Regulations, [20XX].*
- 2. (1) A taxpayer must have in place contemporaneous documentation that verifies that the conditions in its controlled transactions for the relevant tax year are consistent with the arm's length principle.<sup>24</sup>*

*A hypothetical example of shifting the burden of proof* – Shifting the burden of proof where the country has a self-assessment regime will require the taxpayer to compute their taxable income based on the arm's length principle. If they fail to do so, then there could be a penalty for any tax collected due to a transfer pricing adjustment by the tax administration. Failing to retain adequate TP documentation is likely to constitute neglect. The case for such a penalty will be significantly increased if there are statutory TP documentation requirements through TP Documentation Regulations. In addition, it is also recommended that countries have a penalty for failure to retain the TP Documentation stipulated in the Regulations. This

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<sup>23</sup> Ibid., p. 4.

<sup>24</sup> Ibid., p. 14.



will apply whether or not there is a TP adjustment made, meaning there could be two penalties.

### Example 3 - Third party loans and exploiting capital allowances

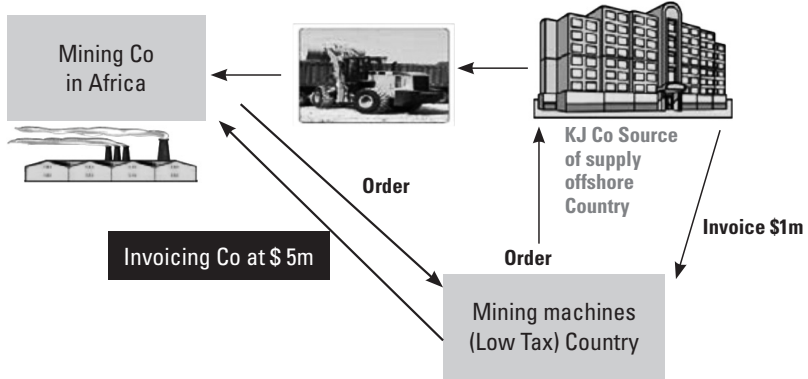


Figure 1: Mining Companies procurement from Manufacturing Companies

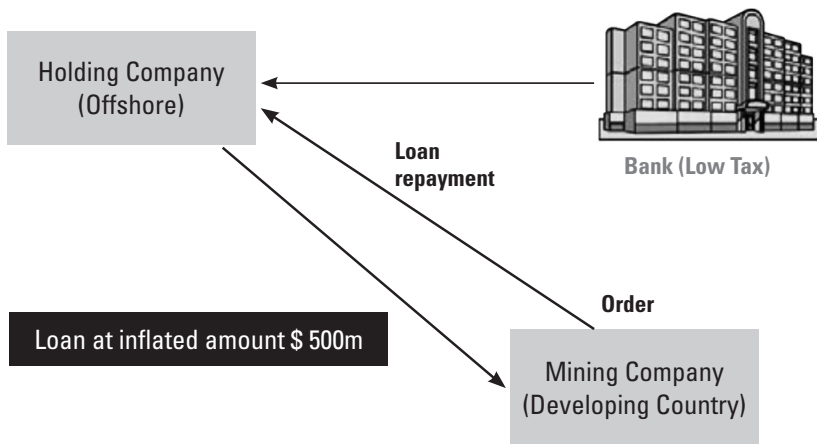


Figure 2: Mining Companies management and engineering (M&E) financing from Offshore Companies

In this example, the African taxpayer is being over-charged for the specialised machinery and claiming excessive tax depreciation charge. The tax risk here is that the equipment is purchased by the low tax jurisdiction company from the third-party manufacturer for its true market value – say \$10 million but sold to the African company by the related party for an inflated price, say \$15 million and this means the African company can claim an inflated tax-deductible depreciation charge (which may be capital allowances) on the \$15 million purchase that should have been \$10 million.

The tax administration finds it difficult to prove that the price has been inflated as they cannot access the invoice from the third-party manufacturer to the related party in the tax haven. The link to tax incentives is that there would often be import duties on the imported machinery which would deter such inflation being used, but tax incentives often exempt these types of imports from such duty. In some cases, the issue was made worse because the African company took out a related party loan to pay this inflated price and therefore benefitted from a second tax deduction for the interest expense.

#### **IX. ATAF SUGGESTED APPROACH TO DRAFTING TRANSFER PRICING LEGISLATION AND SOME EXAMPLES OF ITS PRACTICAL USE**

As part of providing solutions to some of the complex challenges faced by member countries, ATAF has developed a number of products to address risks. At the core of this was the formation of the Cross Border Taxation Technical Committee after the first Africa Consultation on cross-border taxation held in March 2014 in Johannesburg, South Africa, which identified the gap between tax administration and tax policy as one of the key risk elements of taxation.

With the international tax landscape moving to implement the outcomes of the OECD/G20 BEPS process and with Africa losing billions to ill-conceived tax incentives, illicit financial flows and inappropriately formulated laws on natural resources, it is essential that tax policy and tax administration collaborate optimally.

To date, the technical committee, together with the ATAF Secretariat has developed a range of products and specifically on transfer pricing. These are:

- ATAF Risk Assessment Model for TP;
- ATAF Suggested Approach for Drafting Transfer Pricing Legislation

The Suggested Approach has unique features adapted for developing countries, particularly ATAF members. The ATAF membership was consulted at the ATAF Workshop on Transfer Pricing Regimes in Nairobi, Kenya in July 2016.<sup>25</sup> Below is a highlight of some of these features and the wording thereof:

***Subsection 4 (i).*** *The provisions of paragraph 1 shall also apply where a person resident in [Country] engages in one or more transactions with a person located in a tax jurisdiction that the Commissioner-General/Commissioner determines provides a beneficial tax regime, whether or not such a person is a connected person. All such transactions shall be deemed to be controlled transactions for the purposes of Section XX and [Insert relevant secondary legislation/regulation reference]*

***Subsection 4 (ii).*** *The provisions of paragraph 1 shall also apply where a person located in a tax jurisdiction that the Commissioner-General/Commissioner determines provides a beneficial tax regime, engages in one or more transactions that relate to a permanent establishment of a non-resident person in [Country] whether or not such a person is a connected person. All such transactions shall be deemed to be controlled transactions for the purposes of Section XX and [Insert relevant secondary legislation/regulation reference]*

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<sup>25</sup> ATAF Workshop on Transfer Pricing Regimes in Africa (Nairobi, Kenya, 27-28 July 2016), Outcomes Statement.

This section enables the Commissioner-General to apply the transfer pricing legislation to a transaction where one of the parties is located in a tax jurisdiction which the Commissioner-General considers is a beneficial tax regime. Many African tax administrations have reported that they often face risks of tax loss where the local taxpayer has a transaction with a low or no tax jurisdiction, but they are unable to apply their transfer pricing legislation because the taxpayer contends that the person in the low/no tax jurisdiction is unrelated and the tax administrations are unable to obtain the evidence to show they are related. The section allows the Commissioner-General to apply the transfer pricing legislation in these circumstances. Clearly, if the taxpayer satisfies the Commissioner-General that the other person is not related then by definition, the transaction will be arm's length.

***Subsection 13.** Where a person engages in a transaction with a connected person that involves the transfer of rights in an intangible, other than the alienation of an intangible, the deduction allowable for tax purposes in that transaction shall not exceed X% of the [tax EBITDA + plus royalties payable] derived from the commercial activity conducted by the person in which the rights transferred are exploited.*

Many African tax administrations have reported great difficulties determining arm's length prices for royalties and other consideration relating to intangibles and consider that they face a significant risk to their tax base from excessive royalty and other intangible related payments to non-resident related parties. Section 13 provides an alternative approach of the tax-deductible amount of the royalty being restricted to a percentage of the taxpayer's tax EBITDA (earnings before interest, tax, depreciation and amortization) plus the actual royalty payable for the year of assessment.

The following is an illustrative example of how mathematically the rule would work. The example uses a 1% ratio. However, this is for illustrative purposes only and is not an indication of where the percentage should be set.

The rule is 1% of EBITDA plus royalty payable	
EBITDA from activity relating to the intangible	1000
Plus royalty payable relating to the intangible	200
Total	1200
Royalty allowed as tax deductible (1%)	12
Disallowed royalty	1188

**Note:** Countries will need to decide the percentage level for this section.

In the TP Regulations, the ATAF Suggested Approach on Drafting Transfer Pricing Legislation has made some of these unique features:

***[Optional alternative wording for Para 7 (1)]:*** An arm's length range is a range of relevant financial indicator figures (e.g. prices, margins or profit shares) produced by the application of the most appropriate transfer pricing method as set out in Paragraph 5 to a number of uncontrolled transactions, that are all comparable, and equally comparable to the controlled transaction based on a comparability analysis conducted in accordance with Paragraph 4 provided that the highest point in the range is no more than 25% greater than the lowest point in the range.

***[Optional alternative wording for Para 7 (2)]*** Where the application of the most appropriate method results in a number of financial indicators for which the degree of comparability of each to the controlled transactions, and to each other, is uncertain, or the highest point in the range exceeds 25% of the lowest point in the range, a statistical approach shall be used. Where such an approach is used, the interquartile range shall be considered to be an arm's length range.

These provisions narrow the arm's length to remove outliers that may distort the results.

With the inclusion of options for wording, the document aims to give African countries their own choice in wording depending on other domestic law considerations. The several options presented are as a result of the consultations with various countries outside of the member countries in the CBT Technical Committee.

The suggested approaches can be used to address some of the challenges that have been highlighted throughout this chapter. Member countries have reported the various transactions as illustrated, and the ATAF Secretariat has worked to ensure that through innovative legislation, these transactions can be treated in a fair manner that allows both taxpayer and tax administration to apply a reasonable approach with clarity.

## **X. CONCLUSION AND RECOMMENDATIONS**

With the changing global tax agenda and the quest to achieve domestic resource mobilisation, it is prudent for African countries to commence changing their legislation and regulations in relation to transfer pricing. MNEs form a significant part of the tax base of African countries, and while this may not be an ideal tax mix, it is the reality of some of the economies that are emerging as resilient. The logic behind strengthening tax rules is that where there is a weakness of regulation, the taxpayer will take advantage of this. Moreover, the weakness of these rules creates an uphill challenge for tax administrations in auditing.

Transfer pricing on its own requires an investment of huge resources from the side of the tax administration. This is further compounded by the changing nature of transactions. The introduction of new forms of business such as Uber, Airbnb and other online platforms creates challenges for the tax treatment of such transactions. There are also challenges on how to deal with these new forms of business from a VAT point-of-view. Therefore, this again highlights the need for coherent policy formulation.

Through formulation of new legislation and regulations, tax administrations, together with their ministries of finance, are presented with the opportunity of drafting legislation that is line with international best practices, and that is also in line with creating tax certainty. Noting that African countries would like to fulfil the objectives of Agenda 2063, the question is how will it be funded? Stronger policy and legislation that creates a fiscal environment that is both predictable and easy to interpret is a starting point.

New forms of legislation alone will not solve some of the challenges that are persistent. There will still be taxpayers who will run high-risk transactions and those who will have low levels of compliance. However, it is envisaged that the general reform of the tax administration will be working in tandem with the reform of international tax regimes.

ATAF has also commenced a nexus project where tax policymakers and tax administrations are brought together to discuss some of these key developments, identify where blockages occur and what practical solutions are available to ease them. This is a key feature of moving forward in a practical manner for African countries. The BEPS discussion is not over, it is only the beginning, and increasingly, African countries realise the inadequacies of their laws to combat TP abuses.

**ANNEX – TRANSFER PRICING LEGISLATION AT THE END OF 2017**

<b>Country</b>	<b>Implementing Regulations/ Guidance</b>	<b>Effective Documentation Requirements (with a penalty and/or the onus of proof)</b>	<b>Annual Disclosure Requirements (for related-parties transactions)</b>
Angola	Large Taxpayers Statute 2013 and Circular N.12/ DLT/DNI/2014	Yes	Yes, from 2015
Botswana	Transfer pricing (TP) rules currently being developed. Arms Length Principle (ALP) in General Income Tax Law	No	No
Burkina Faso	Art. 22 of General Tax Code	No. No Transfer Pricing (TP)-specific penalties	No
Burundi	No formal rules. ALP in General Income Tax Law	No	No
Cameroon	2012 Finance Law	Yes	Yes, on request
Côte d'Ivoire	Anti-avoidance rules in Art. 38 of CODE GENERALDES IMPÔTS (CGI)	Yes. No TP-specific penalties	No, on request



Ghana	Sec. 70 of Internal Revenue Act (IRA)	Yes	Yes
Kenya	C.470 of Income Tax Act (ITA)	Yes	Yes (but not yet widespread)
Lesotho	No formal rules. ALP in General Income Tax Law	No	No
Madagascar	Anti-avoidance rules in A.010115 of CGI	Yes	Not specific
Malawi <sup>26</sup>	C. 41 of ITA	Yes. No TP-specific penalties	No, on request
Mozambique	A. 58 of Corporate Income Tax Code	No. No TP-specific penalties	No
Namibia	Sec. 95(a) of the Income Tax Act	No. No TP-specific penalties	No
Nigeria	Income Tax (Transfer Pricing) Regulations	Yes. No TP-specific penalties	No, on request
Senegal	Art. 17 of CGI	Yes. No TP-specific penalties	No, on request

<sup>26</sup> The Malawi Revenue Authority engaged ATAF to amend its current TP regulations. These have been gazetted and signed by the President on August 2017.

South Africa	Taxation Laws Amendment Act N.7	Yes	Yes
Tanzania	Anti-avoidance Sec. 33 of ITA Act	No. Discretionary penalty powers	Yes
Uganda	C. 340 of ITA	Yes	No, on request
Zambia	S. 97A of ITA	Yes. No TP-specific penalties	No, on request
Zimbabwe	TP provisions introduced in 2015 as part of the Income Tax Code	Yes	Yes

Sources: This study's TP questionnaires and recent TP Country Summaries by Transfer Pricing Associates, PWC, KPMG and Grant-Thornton. Additional information from the ATAF Secretariat.

# **CHAPTER 6**

## **EXCHANGE OF INFORMATION: INDIAN EXPERIENCE, DEVELOPING COUNTRY IMPLICATIONS<sup>1</sup>**

Jahanzeb Akhtar

### **I. INTRODUCTION**

Cross border tax evasion scandals and illicit financial flows have dominated public discourse since 2008 with whistleblower leaks contributing to the drama in the discussion. Aggressive tax planning is the vehicle of multinational enterprises (MNEs) for artificially shifting corporate profits to low/no tax jurisdictions and avoid paying taxes in countries where their businesses are located and value is created. High net worth individuals (HNWIs) use secrecy jurisdictions to park their illegal assets and income to avoid detection and tax payment in their countries of residence. Together, these MNEs and HNWIs deplete the legitimate tax revenue of nations. While tax losses have been significant for developed countries,<sup>2</sup> offshore tax evasion impacts developing and emerging economies disproportionately. Compared to just 2% of US household wealth managed offshore, the estimate for Latin America is more than one quarter and for all Middle Eastern and African countries it is one third (The Boston Consulting Group, 2013).

Numerous studies have documented such disproportionate sufferance of developing countries from tax bleeds. A 2015 International Monetary Fund (IMF) study of 173 countries over 33 years found that Corporate Income Tax (CIT) revenue loss due to profit shifting and base erosion of MNEs are three times larger in developing countries than in

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 4 (September 2018).

<sup>2</sup> In 2012 US multinationals alone shifted \$500-700 billion to low/no tax jurisdictions; this amounted to approximately 25% of their annual profits. See Weyzig (2015).

Member Countries of the Organisation for Economic Co-operation and Development (OECD) (Crivelli et al., 2015, p. 20). Developing countries are estimated to lose \$100 billion annually, being one third of their total CIT base, due to aggressive tax avoidance using tax havens (UNCTAD, 2015, p. 200), with revenue loss from corporate tax machinations being higher than the Official Development Assistance (ODA) received (Christian Aid, 2008). Illicit financial flows, growing over the years (Kar & Spanjers, 2014), are perpetuated by opacity in the global financial system. Since corporate taxes represent a larger share of total tax revenue in developing countries compared to their developed counterparts (IMF, 2014) the cost of tax dodging by MNEs is roughly 30% higher in developing countries than in OECD countries (Action Aid, 2015).

The challenges of tax administration in a fluid and opaque global financial environment include, amongst others, meaningful access to tax related information through relationships of exchange between governments. Such exchanges of information (EOI) are of 3 kinds – “spontaneous”, “upon request” and “automatic” (OECD, 2006). This chapter looks at India’s experience with EOI over the years, having been a front ranker, both individually and as a Group of Twenty (G-20) member, in the pursuit of international cooperation in this regard.

India’s experience with “spontaneous” exchange of information has been limited, with the HSBC accounts of Indian taxpayers shared by the French authorities being the best known example since the matter went before the higher judiciary. The effectiveness of this mechanism depends upon the initiative of the tax officials in the information sending country. Hence, strategies for its promotion through means such as annual reporting of numbers are still untested for efficacy. This chapter, therefore, has concentrated on the “request” and “automatic” modes of exchanges respectively in the next two sections. India’s capacity in domestic and international tax administration is acknowledged, as is its influence as a fast growing emerging economy.

Hence, its experience with EOI has important lessons for other developing countries, apart from lessons in leadership, fairness and equity.

## **II. EXCHANGE OF INFORMATION UPON REQUEST (EOIR) IN INDIA**

### ***II.1 Legal foundation & administrative set up***

A large network of bilateral Double Taxation Avoidance Agreements (DTAAs), 134 at last count,<sup>3</sup> are at the foundation of India's long association with international EOI. The DTAAs contain elements from the "OECD Model Convention with Respect to Taxes on Income and on Capital" (OECD Model Convention) and the "United Nations Model Double Taxation Convention between Developed and Developing Countries" (UN Model Convention). India is the first country outside the membership of the OECD and the Council of Europe to sign and ratify the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention) in 2012.<sup>4</sup>

It has also signed 18 Tax Information Exchange Agreements (TIEAs), following the model developed by the OECD led Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum).

The above legal instruments, underpinning both "spontaneous" and "upon request" sharing of information, specify the duty to exchange information under Article 26 of the DTAAs, in both the OECD as well as in the UN Model Convention. The information must be "foreseeably relevant" for carrying out the provisions of the treaty or for administration of the domestic tax laws of the requesting country, thereby ruling out "fishing expeditions". All information, including from banks and fiduciaries, is included in the scope of "request" without linking it to a domestic tax interest of the requested jurisdiction or the application of standards of dual criminality. A corresponding legal obligation is cast on the requesting jurisdiction to protect the confidentiality of tax payer information.

The TIEAs, also utilized for exchange of information "upon request" for both civil and criminal matters, can be either bilateral

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<sup>3</sup> [www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx](http://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx)

<sup>4</sup> <http://www.oecd.org/india/taxindiaratifiesconventiononmutualadministrativeassistanceintaxmatters.htm>

or multilateral. India has bilateral TIEAs with many secrecy jurisdictions - Bermuda, Cayman Islands, Jersey, British Virgin Islands, Bahamas etc. - where DTAAs are not relevant, absent the risk of double taxation. Unlike the DTAAs the TIEAs are applicable only in respect of the taxes listed in the agreement and not taxes of every kind. Along with bilateral agreements for EOI several regional agreements have also been signed by India, such as with the South Asian Association for Regional Cooperation (SAARC) for avoidance of double taxation and mutual administrative assistance in tax matters.

EOIR had been promoted by the OECD as the “internationally agreed standard” on transparency and exchange of information. Through a peer review process the “restructured OECD monitors that its members fully implement the standard of transparency and exchange of information that they have committed to implement”.<sup>5</sup> What is left unsaid is that the EOIR framework, including the scope of Article 26 and the TIEAs, were substantially finalized by the OECD and its Global Forum much prior to the latter’s restructuring in 2009. There was, therefore, no participation of the developing countries in norm setting for transparency which they had committed to implement and be reviewed for. India, which has membership of the Global Forum but “observer” status in OECD, has been covered in the peer reviews Phase 1 and 2 with a rating of “compliant”. It is currently engaged in the second round of reviews based on the 2016 Terms of Reference which include additional details of beneficial ownership.

A well manned Directorate of Foreign Tax and Tax Research (FT&TR) in the Government of India, consisting of two Joint Secretary rank officers with an active EOI cell (since 2012), is tasked with implementation of the treaty obligations for EOI. No information on EOI is shared in the public domain, not even on non-confidential aspects such as the number of requests received from and sent out to other countries. Such organizational maturity and confidence in supporting transparency, besides assisting academic and research

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<sup>5</sup> [www.oecd.org/tax/transparency/](http://www.oecd.org/tax/transparency/)

efforts in this area, is expected to develop very slowly. Apart from a Manual on Exchange of Information for the assistance of tax officers who send out requests for information<sup>6</sup> no other material/data is placed in the public domain by FT&TR. They are, however, submitted to the Global Forum for peer review and are finally available through the public reports of such review. This author was unable to access recent statistics on the number of queries sent out by FT&TR and the volume of such queries received.

From India's Phase 2 peer review report (OECD Global Forum, 2013) and the author's domain conversations it is known that the Indian Competent Authority sends out a much larger volume of queries than it receives. From 29 outbound requests in 2008 the number has risen to 884 in 2013 and 1600 in 2014 (OECD Global Forum, 2015; CBGA, 2016). The information for the period thereafter is not available. By contrast, the number of annual requests received up to 2013 has averaged 34 (OECD Global Forum, 2015, p. 96); the increase in later years is not known to be significant.

## ***II.2 Study on end user experience with EOIR***

Given the absence of public data, this author conducted a survey of a sample of tax officers in the field to understand how the operation of the EOIR instruments, conducted through the Competent Authority, has benefited the ultimate user of the requested information. The existing system of qualitative feedback from tax officers, required by FT&TR on receipt of the information, neither shares them publicly nor maintains them as a data base. It is understood that the lack of anonymity mostly produces "safe"/ non-committal responses even when the requested information was not received or was not useful.

In the present study, a questionnaire was administered to the tax officers who had identified foreign transactions for further investigation during an audit of the resident taxpayer or the one engaged in a "source" transaction in the country. Identification of this universe for selecting a sample involved a certain "purposive"

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<sup>6</sup> <http://taxguru.in/wp-content/uploads/2015/07/Manual-of-EOI-2015-31-07-2015.pdf>

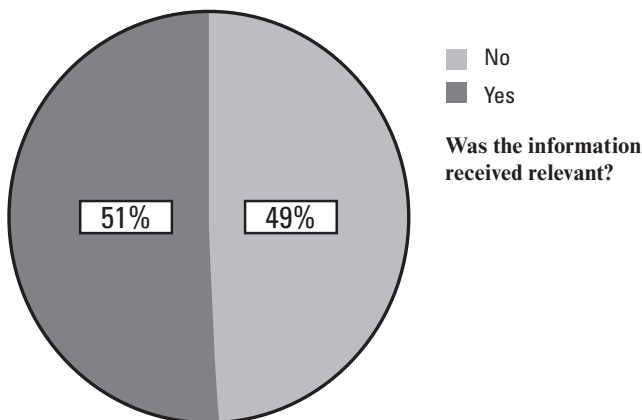
effort using peer information since there is no data-base maintained of such foreign transactions or the tax officers who have handled their audit. The “Assessing officers” were randomly selected from different parts of the country and the responses were taken anonymously. 65 responses, representing about 15% of the “universe”, were finally analysed. Most of the officers had sent out multiple requests for information, contributing to the large numbers reported in the peer review. Anonymity was a critical requirement since the closed bureaucratic hierarchy of the organization precludes openness in communication, sharing of ideas and suggestions under normal channels of formal/ informal communication. Several in-depth focus group discussions were additionally done to identify hidden drivers, meanings and motivations which, combined with the author’s domain experience, were used for data interpretation.

The result of the above exercise, albeit limited in scope, revealed a widespread sense of frustration with the outcome of the “request” efforts initiated by the tax officers. Under the prevailing procedure, the form containing the request, along with background data explaining its context, starts its journey from the officer who has identified the foreign transaction of the taxpayer under audit. However, he/she does not sign the request. The form wends its way to the immediate supervisory authority i.e. the Joint/Additional Commissioner and, thence, to the Principal Commissioner who formally signs the request form addressed to the Competent Authority. The latter, after a *prima facie* confirmation that the information sought has “foreseeable relevance” to the matter and the taxpayer being investigated, sends it to the Competent Authority in the foreign jurisdiction. Queries and clarifications sought by the foreign authorities travel this path in reverse until they reach the auditing tax officer.

The study indicated that the practice of seeking information from foreign jurisdictions is fairly well known to tax officers (95%) but the relevance of the information received was suspect. 49% of the respondents who had received replies answered in the negative to the question “Was the reply/information provided by the foreign country relevant to your query?”



**Figure 1: Responses on relevance of information received under EOIR**

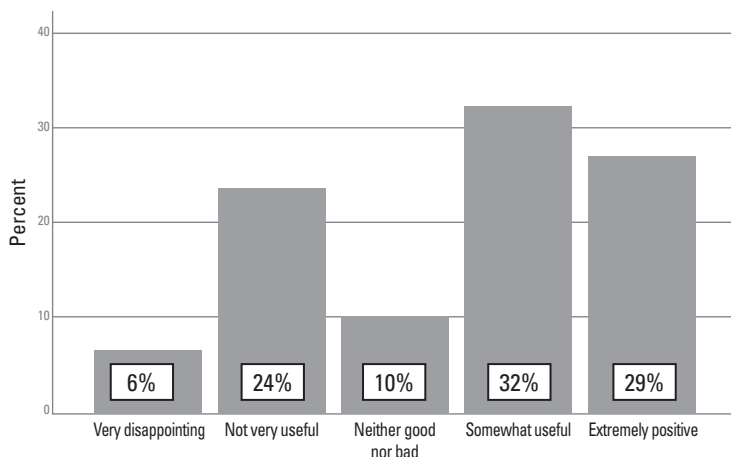


The problems in the information received ranged from “vague/misleading reply” (32%), “no information sent stating link to Indian taxpayer not clear” (18%) to “other reasons” (29%) which included delayed, partial, incomplete, rhetorical and haphazard replies. One common complaint was that these replies often skirted the issues of round tripping of funds and related tax evasion that are targeted in the audits. Even apparently simple information such as copies of accounts of the Indian taxpayer in the books of the foreign entity were not sent. When the Indian taxpayer is a large multinational claiming exempt income, the suspicion of deliberate stalling by the foreign jurisdiction in sharing information is often not unfounded. Repeated clarifications are sought by the foreign jurisdictions even when a detailed background note explaining the context, connection and reason for the query accompanies the EOIR request. As one of the tax officers commented – “the stance seems to be to avoid information giving.”

The Income Tax Act of 1961 allows an extension of the limitation period for audit by keeping the process on halt, up to a year, while the query to the foreign Competent Authority awaits an answer. Senior officials in the FT&TR attribute the limited success of the EOIR mechanism to its cynical use by tax officers only to “buy extra time”. Strong views have also been expressed in the FT&TR about

the quality of drafting of the information queried by the tax officers initiating the EOIR process, attributing the limited success of the provisions to this quality deficit.

Backed by anonymity, 75% of the respondents surveyed admitted to having used the provisions for seeking extra time but it was emphasized that this was only one amongst multiple reasons behind the request made through FT&TR. In a hierarchy bound organizational culture beset with closed communication (Akhtar, 2012) the response on the overall experience with the FT&TR and the EOIR process required anonymity to remove the bias of political correctness. About 30% reported a negative experience while 10% were neutral (Fig. 2). The focus group discussions were particularly stinging on this aspect.



**Figure 2: Overall experience of requisitioning information through FT&TR**

In the focus group discussions, the tax officers bemoaned the lack of value addition in drafting from the Principal Commissioners who signed the request form or the FT&TR Directorate which finally sent it abroad. Most of the officers seemed convinced that the tax haven jurisdictions, as also many developed countries, were simply not interested in sharing the requested information and the delay,

prevarication and multiple clarifications sought were merely a way of communicating this aversion to sharing. Many of the surveyed tax officers rued entering the “labyrinth” of EOIR in the first place.

The phenomenon of illicit financial flows into tax havens and developed jurisdictions co-exists with round tripping of funds, especially when the recipient market is strong and investment opportunities attractive, as in India. Enforcement actions by the Income Tax Department through searches and seizures frequently unearth this. However, the reluctance of the relevant foreign jurisdictions for sharing details, including bank information, to verify the claims of available funds for investment, renders the entire exercise form-based and futile. As one of the respondents lamented - “Information was not useful since round tripping angle and layering was not covered in the information sent. Information only confirmed what was already known, like giving a certificate to the assessee” (taxpayer).

As far as responding to requests of foreign Competent Authorities is concerned the Global Forum peer review Phase 2 has lauded the completeness and meticulousness with which information is obtained in India and shared with the requesting government. Not a single request has been turned down for any reason.

### **III. AUTOMATIC EXCHANGE OF INFORMATION (AEOI) IN INDIA**

Automatic Exchange of Information (AEOI) is crucial for jurisdictions that tax their residents on their global income. Its effect is principally deterrent, although it also ensures equal treatment of the domestic and foreign source income of the resident taxpayer and removes tax distortions in allocation of financial resources offshore (Urinov, 2015). AEOI is not included in either the OECD or the UN Tax Model although their commentaries refer to its possibility. The Multilateral Convention, however, can accommodate its practice through specific terms of agreement between signatories. Today AEOI is understood in terms of routine collection of tax relevant information about non-resident taxpayers in the source country and its periodic transmission to the tax authorities of the country of residence of those taxpayers (OECD Global Forum, 2014). The three modes of AEOI currently in place in India are discussed below.

### **III.1 FATCA through IGA**

Information on overseas accounts held by US taxpayers is obtained by the Internal Revenue Service (IRS) through the 2010 US Foreign Account Tax Compliance Act (FATCA) with a provision for 30% withholding tax on Foreign Financial Institutions (FFIs) which do not agree for such reporting. India signed the Inter-Governmental Agreement (IGA) for implementing FATCA based on the reciprocal Model 1A in July 2015.

Full reciprocity is not available under the IGA since the US IRS is empowered to receive information about US citizens and residents as well as non US entities with one or more US controlling persons, but US domestic law does not permit collection of “beneficial owner” information. Not surprisingly, this is the information that countries suffering a leaching of their tax base are most concerned about. India sends out account information with more details than it receives. The need for reciprocity has been endorsed by the US in Article 6 of the IGA with India but the legislation for this purpose is still awaited.<sup>7</sup> The lack of reciprocity and asymmetry in the due diligence requirement have been issues of concern for financial institutions and market regulators in India.<sup>8</sup>

Absent any public consultation before introducing FATCA it is not known whether the Indian policy makers were aware that the FATCA, as passed by the US Congress within the Hiring Incentives to Restore Employment Act (HIRE Act),<sup>9</sup> has no mention of reciprocity although it was promised by the executive branch of the US government. In fact, some consider the IGAs “constitutionally suspect”, because of the lack of statutory authority given by the Congress to the US IRS in this regard (Christians, 2014). The hearings, since April 2017, before the Oversight and Government Reform Committee of the US Congress on the unintended consequences of FATCA<sup>10</sup> have highlighted such nebulous issues.

<sup>7</sup> <https://www.treasury.gov/press-center/press-releases/Documents/Lew%20to%20Ryan%20on%20CDD.PDF>

<sup>8</sup> [http://www.business-standard.com/article/markets/sebi-flags-down-govt-on-india-us-tax-pact-114122900041\\_1.html](http://www.business-standard.com/article/markets/sebi-flags-down-govt-on-india-us-tax-pact-114122900041_1.html)

<sup>9</sup> <https://www.govtrack.us/congress/bills/111/hr2847/text>

<sup>10</sup> <https://oversight.house.gov/hearing/reviewing-unintended-consequences-foreign-account-tax-compliance-act/>

FATCA's introduction was facilitated in India in 2014 by amending section 285BA of the Income Tax Act 1961 and bringing three new rules into the Income Tax Rules, 1962 – Rules 114F to 114H. Thereby, the banking secrecy laws were legally circumvented and legal underpinnings were provided to Reporting Financial Institutions (RFIs) for reporting on the “Reportable Accounts”. Unlike many other countries, India has employed the same primary and secondary legislation to implement both FATCA and the Common Reporting Standards (CRS) on AEOI, with the information available under both to be used solely for tax purposes. A detailed guidance note has also been issued.<sup>11</sup> Penalties have been provided under sections 271FA and 271FAA for defaults in reporting. Admittedly, however, the enforcement strength of such discretionary penalties is weaker than the threat of 30% withholding tax that the IGA brandishes under FATCA.

From a public international law perspective, the unabashedly extra territorial nature of FATCA's design, with threat of 30% withholding, has often been critiqued (Mukadi, 2012), to the extent of considering it “imperialist”.<sup>12</sup> Even though the IGA resolves the problem of incompatibility with national laws and bank confidentiality rules it is, at best, a technical solution which leaves unresolved the overreaching US dominance in the arrangement. India, it would appear, is far from a just and “win-win” scenario in this “exchange” when lack of full reciprocity makes the FATCA one sided in protecting only the US tax base. Since the US used the FATCA rationale for staying out of the OECD led CRS it diluted the “global” identity of the latter too (Holm, 2014).

FATCA's implementation necessitates high compliance costs for financial institutions in enhancing processes and computer systems, educating potential investors on new disclosure norms and upgrading their centralized customer data bases. Even in the US the estimates of additional revenue raised is far lower than the cost of implementing FATCA. In fact, the US Treasury Department's estimate of annual extra revenue of only \$800 million<sup>13</sup> from FATCA seems like a sledgehammer taken to a nut. When the capacity of the US IRS to use the gigantic

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<sup>11</sup> <http://incometaxindia.gov.in/news/guidance-note-for-fatca-crts-31-12-2015.pdf>

<sup>12</sup> <https://www.wsj.com/articles/taming-irs-imperialism-1486166764>

<sup>13</sup> <https://www.taxnotes.com/tax-notes/fatca/overview-fatca/2016/08/29/r2jh>

information it receives under FATCA has itself been questioned (National Taxpayer Advocate, 2016) the benefit to India, purely from information exchange, remains anybody's guess.

### ***III.2 Common Reporting Standards (CRS) for AEOI***

In carrying out the Group of 20 (G20)'s mandate "for all jurisdictions to move towards exchanging information automatically with their treaty partners, as appropriate"<sup>14</sup> the OECD proposed the Common Reporting Standards (CRS), a framework containing reporting requirements and due diligence rules for financial institutions, and a Model Competent Authority Agreement (MCAA)<sup>15</sup> that states could sign for implementing automatic exchange with a treaty partner. Together they constitute the "AEOI Standard". The implementing procedure involves amending the domestic law to incorporate CRS, concluding Competent Authority Agreements on bilateral or multilateral basis, creating the information technology (IT) and administrative infrastructure for AEOI and ensuring confidentiality and data safeguards for the exchanged information. A Common Transmission System (CTS) developed by the Global Forum claims to use the best industry standards of encryption for exchanging information between jurisdictions.

The MCAA for CRS is the legal instrument linked to Article 6 of the Multilateral Convention where the possibility of AEOI has been envisioned. India was amongst the "early adopters" of the AEOI Standards and it signed the MCAA in June 2015 committing to the first exchange in September 2017. As of May 2017 45 exchange relationships "from" India and 55 "to" India had been established.<sup>16</sup> As of June 2017 93 jurisdictions had signed the MCAA with commitments to start AEOI from September 2017 or 2018.<sup>17</sup>

The multilateralism on which MCAA is premised is limited by the discretion of individual country signatories to choose the jurisdictions

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<sup>14</sup> [http://www.mof.go.jp/english/international\\_policy/convention/g20/20130419.htm](http://www.mof.go.jp/english/international_policy/convention/g20/20130419.htm)

<sup>15</sup> <https://www.oecd.org/tax/exchange-of-tax-information/multilateral-competent-authority-agreement.pdf>

<sup>16</sup> <http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/exchange-relationships/>

<sup>17</sup> <https://www.oecd.org/ctp/exchange-of-tax-information/MCAA-Signatories.pdf>

that they wish to exchange information with. This “hidden and dangerous bilateralism within the promised multilateralism” (Urinov, 2015, p.12) can further marginalize developing countries unable to meet rigid eligibility conditions (Ring, 2014; Ring, 2017). Switzerland, for instance, has only chosen jurisdictions with which it has close economic and market interests. In June 2017 the Swiss Federal Council ratified AEOI with India and 40 other jurisdictions where data exchanges will start from 2019. The question of the value of MCAA for those signatory countries which are not selected by some /all of the other signatory parties remains unanswered.

While the benefits from automatic exchange through CRS can be evaluated only after data has flown for a reasonable period, India’s experience, as a large emerging economy, in the design of the framework carries lessons for its developing country peers. A point of concern for this author has been the G-20’s selection of OECD as their default organization of choice for the initiatives of tax transparency and anti-profit shifting. For all its claims of restructured and wider membership to represent developing country interests, the Global Forum, in the ultimate analysis, remains anchored in the OECD (Abebe et al, 2012) and has been accused of lack of rigour in ensuring the representation of developing country voices. Its tokenism in consulting developing countries was well recorded when survey questions were framed with a developed country focus (Knobel and Meinzer, 2014) and its recommendations published even before close of the survey date.

The overwhelming shadow of the agenda of OECD member states could have been anticipated by the developing countries within G20 and balanced through a multi institutional forum tasked with developing the new global standards for automatic exchange. The more representative UN Tax Committee of Experts and the Geneva based South Centre, along with the Global Forum, might have increased the legitimacy quotient of the exercise. India’s weight was expected to be cast in this direction instead of quietly endorsing the choice of the developed countries in the G20.

The CRS design, incorporating full reciprocity (Section 7 of MCAA) is seen as leaving poorly resourced countries out of exchange benefits.

The only possibility for non-reciprocal participation in the MCAA is provided for countries which do “not need to be reciprocal”, mainly because one of the jurisdiction does not have an income tax. Under these arrangements the AEOI effectively becomes exchange from tax havens, although the desirable model should have been non-reciprocal to a developing country. The “complexity and incoherence of the regulatory framework” of the CRS has been noted by analysts (Gadzo and Klemencic, 2017) who find it too ambitious when juxtaposed against the EOI systems still prevalent. The constraints of budgetary, administrative and technological capacity of developing countries is likely to keep them out of MCAA to receive information even though the likelihood of their taxpayers having parked their assets in developed jurisdictions is much higher than the opposite scenario. The intermediate solutions of “staged reciprocity” (Tax Justice Network, 2014, p. 5) in which the initial focus is on information transfer to, instead of exchange with, developing countries for a specified grace period, however, has not found acceptance. Unlike the FATCA regime, the sanctions to be applied to non-participants are also non-existent, posing problems in getting tax havens to sign up bilaterally with developing countries.

### ***III.3 Country by Country reporting (CbCr)***

The Base Erosion and Profit Shifting (BEPS) project of OECD, in its Action Item 13 report (Transfer Pricing Documentation and Country-by-Country-Reporting), contains the most recent disclosure and transparency effort in international taxation. In being ranked “high” in relevance to developing countries (OECD, 2014) it raised expectations that the information asymmetry between tax authorities and tax payers in these countries would be finally addressed. This asymmetry was especially problematic when tax authorities had no access to systematic and comprehensive data on the activity structures, operations and intra group transactions for evaluating the global value chains of MNEs.

The CbC reporting template requires MNEs to provide all relevant jurisdictions where they do business with needed information on their global allocation of income, economic activity and taxes paid among countries, along with certain indicators of the location of economic activity. The CbC report is to be filed in the jurisdiction of the tax residence of the “Ultimate Parent Entity” and shared between other



concerned jurisdictions through automatic exchange of information. The OECD has developed a Multilateral Competent Authority Agreement on the Exchange of CbC reports (CbC MCAA),<sup>18</sup> which can be exchanged either under DTAAAs or TIEAs.

In 2016, India introduced section 286 in its Income Tax Act 1961 to implement CbCr in respect of an international group by its constituent or parent entity. The rules were notified after examining the recommendations of the Committee set up for this purpose and taking suggestions from various stakeholders. The first round of CbC reports, with group threshold of turnover exceeding Euro 750 million in the immediately preceding year, have been filed with the Indian authorities by 31<sup>st</sup> March 2018. This has been acknowledged as a very high threshold, with even the OECD estimating that it excludes 85-90% of all transnational corporations (TNCs) from reporting (OECD, 2015A). For developing countries, where smaller MNEs may be the largest foreign direct investors, the threshold is especially questionable. Stiff penalties have been prescribed for failures and inaccuracies in filing and for non-maintenance of transfer pricing documentation.

The underlying principle of CbCr - transparency and disclosure to arrest base erosion and profit shifting - can be meaningful only if implemented in the spirit of access instead of denial. Using CbCr tax authorities can cost effectively assess the risk that the constituent members of MNEs operating in their jurisdiction are avoiding tax. It is also important to address MNE apprehensions that a tool of risk assessment could, in low capacity countries, become a “backstop” method for tax adjustment (Ring, 2017, p. 1816).

The multi factor CbC report has the potential to be used as a formulary apportionment approach which OECD has so far been loath to endorse - “this approach implicitly accepts the principle behind unitary taxation even if the system is not then used to assess the resulting profits. This point is important: using a unitary taxation approach to tax risk assessment does not require using unitary taxation to assess the resulting dues” (Murphy, 2016, p. 105). India’s skilled Transfer Pricing Officers could be trained for such “smart” usage of the CbCr.

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<sup>18</sup> <http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/country-by-country-reporting.htm>

CbCr has faced strong opposition “from big business and their advisers...Global companies fear being held to account locally” (Murphy, 2016, p. 109). However, the strongest critique by developing countries is around the confidentiality of CbCr when public reporting would benefit those jurisdictions that lack present capacity to join the multilateral framework. In the European Union large financial institutions and large corporations, including those from the extractive industry, are required to do so on various parameters, under the conviction that “public transparency on tax is also an important part of companies” corporate social responsibility”.<sup>19</sup> In recent months, however, there have been attempts to dilute such transparency directives. The USA has repealed the relevant section 1504 of the Dodd Frank Act<sup>20</sup> implemented by the Securities Exchange Commission in respect of oil and gas companies while the European Parliament has accepted amendments in a draft Directive which allow nations to exempt public reporting on aspects related to “commercial confidentiality”.<sup>21</sup>

In countries with weak administrative capacity such public information can be used by additional stakeholders to flag indicators of enhanced risk to the tax authorities. Civil society assessments indicate that the costs associated with making CbCr public is “negligible” (Financial Transparency, 2016) whereas the benefits from equity through level playing fields between multinationals and domestic enterprise are very significant. In fact, the Trade Union Advisory Committee of the OECD itself has reported that “the advantages of public C-b-C far surpass any potential disadvantages” (TUAC for OECD, 2016, p. 2).

Against the above background of existing practices, the OECD’s model of confidentiality imposed on signing countries is clearly balanced in favour of MNE interests.

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<sup>19</sup> [http://europa.eu/rapid/press-release\\_MEMO-16-1351\\_en.htm](http://europa.eu/rapid/press-release_MEMO-16-1351_en.htm)

<sup>20</sup> <http://thehill.com/policy/energy-environment/317700-senate-votes-to-repeal-transparency-rule-for-oil-companies>

<sup>21</sup> [https://www.europarl.europa.eu/RegData/etudes/BRIE/2017/595867/EPRS\\_BRI\(2017\)595867\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2017/595867/EPRS_BRI(2017)595867_EN.pdf)

#### **IV. REFLECTIONS AND LESSONS FOR DEVELOPING COUNTRIES**

Developing countries require additional funds to achieve the Sustainable Development Goals (SDGs) - estimates vary from a conservative additional \$2.5 trillion a year (UNCTAD, 2014) to a realistic \$ 3.5 to \$5 trillion annually<sup>22</sup> (Deen, 2015). As international aid out-flows have fallen, with Official Development Assistance far behind commitment (UN DESA, 2013) and illicit financial flows undermining financial sovereignty (High Level Panel on IFF from Africa, 2015), the emphasis on taxes as the most certain, legitimate and democratic source of Domestic Resource Mobilization has gained international traction in the development discourse and policy forums. Access to information by developing countries on the complete global transactions of taxpayers is central to the correct levy and collection of tax in a world of mobile capital and opaque financial institutions. The criticality of “Exchange of Information” for optimal tax administration, therefore, cannot be over stressed.

The implications of India’s experience with Exchange of Information for other developing countries are discussed below.

##### ***IV.1 Political will***

The decision to participate in information exchange arrangements with the intent to prevent tax evasion and base shifting is disproportionately driven by political factors and will. India suffers the burden of a large “black money” sector (Kumar, 2017). A substantial part of this tax evaded money, including those with dubious and illegal sources of origin, is believed to be parked outside the country. The Swiss government had refused to share details (under treaty requested EOI) of the 1195 HSBC accounts of Indians revealed by a whistleblower, citing the “stolen” nature of the data. A shrill political rhetoric around illicit financial flows in the 2009 Indian Parliamentary election fueled the demand for investigation into the HSBC accounts. A Special Investigation Team (SIT) headed by a retired Judge of the Supreme Court was set up to investigate the unaccounted money kept outside the country, including in HSBC and Liechtenstein accounts, and take steps for its return. It is notable

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<sup>22</sup> Ambassador Macharia Kamau of Kenya, Co-facilitator of the UN SDG process

that although the Supreme Court direction had come in 2011 the SIT was constituted only in 2014, marking the importance of political will in addressing issues of illicit financial flows.

After renegotiating the DTAA with Switzerland through a Protocol in 2011, to align it with Article 26, the HSBC account information on 700 accounts, shared by the French Government with India under spontaneous exchange that year, was considered covered under the amended treaty terms. However, since the information to be requested could only be for 2011 and later years, the value of the new treaty terms on exchange of information was, at best, limited. Indian money in Swiss banks, however, has nearly halved by 2016, slipping to 88<sup>th</sup> place from 37<sup>th</sup> in 2004,<sup>23</sup> having either moved to other locations or “round tripped” home.

The Indian experience with Swiss banks and their secrecy norms bears comparison with the ability of the US IRS in 2009 to obtain 4450 names of US clients, along with a hefty penalty from UBS, for aiding tax evasion by US taxpayers. The power of controlling access to a US domiciled dollar correspondence bank could have been used to hurt UBS terminally. Developing countries lack such muscularity on their own, but their attractiveness as investment destinations for MNEs can provide the requisite strength to negotiate higher transparency with secrecy jurisdictions. It is debatable whether India could have linked its operating licenses for Swiss banks, or inward foreign direct investment (FDI) and market access requests from Swiss companies, to tax cooperation by the Swiss financial industry. But it is undisputed that sanctions, combined with prioritization of country interest, determines the ferocity of negotiations as well as the strength of country groupings that engage with secrecy jurisdictions. Political will is central to propelling this process.

#### ***IV.2 Sharing cost-benefit information***

For a resource strapped developing country the decision to induct an information exchange apparatus in its tax administration is a difficult one, especially if its political elite is corrupt and endorses or benefits from illicit financial flows out of the country. Civil society pressures would be vastly buttressed in such a country if publicly shared information from

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<sup>23</sup> <http://www.thehindu.com/business/Economy/money-in-swiss-banks-india-slips-to-88th-place-uk-on-top/article19198108.ece>

peer countries is available to evaluate the costs with benefits. India has so far been modest, nay shy, of information sharing in this matter, even when confidential information is not involved. For instance, details of budgetary allocation for implementation of technology, training and manpower for EOI, revenue gains from use of exchanged data in audits and investigations, the perceptions and experience of tax officials highlighting gaps between the form and substance of EOI is currently not available in the public sphere. In fact, groups like Brazil, Russia, India, China and South Africa (BRICS) and SAARC could generate such information from their member countries in a standardized format and share it widely as their public goods contribution.

In respect of FATCA, where the cost generating obligations are very substantial, India would do well to share information in the public domain on public and private funds invested to actualize this process, along with a detailed cost-benefit analysis of its own efforts. Civil society and other jurisdictions could critically evaluate these dimensions for their own learning. This is particularly important considering that a proper cost-benefit analysis does not seem to have been done even for the US by the appropriate Committee of Ways and Means of the US Congress prior to passage of this legislation.<sup>24</sup> The cost to other developed countries has also been very high - New Zealand's cost to Government 20,600,000 NZD and to FIs 100 million NZD,<sup>25</sup> Australia's cost A\$255 million and annual maintenance A\$22.7 million,<sup>26</sup> UK's cost 1.1 billion pounds to 2 billion pounds in first 5 years.<sup>27</sup> In this background, developing country cooperation in sharing cost-benefit information will be crucial for the implementation process beyond the ramrod of US' global clout and 30% withholding leverage.

### ***IV.3 Multilateral should remain multilateral***

Developing countries suffer from rampant illicit capital haemorrhage when offshore financial centres function under the cloak of secrecy laws.

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<sup>24</sup> Congressman Mark Meadows in the hearing on Unintended consequences of FATCA at <https://www.youtube.com/watch?v=rV5FpIn3Eyg>

<sup>25</sup> <http://www.treasury.govt.nz/downloads/pdfs/b14-info/b14-2828155.pdf>

<sup>26</sup> [http://www.austlii.edu.au/au/legis/cth/bill\\_em/tlaotfab2014510/memo\\_0.html](http://www.austlii.edu.au/au/legis/cth/bill_em/tlaotfab2014510/memo_0.html)

<sup>27</sup> <https://www.lexology.com/library/detail.aspx?g=a74e2969-7fe3-4931-999b-7caaf60c5588>

Not much appears to be changing under a multilateral arrangement for automatic exchange when countries have the choice of selecting treaty partners, i.e. imposing bilateralism, even after signing the multilateral instrument. They can end up veering away from developing countries that most desperately need the information in the first place. The stated ground i.e. individual country's satisfaction with confidentiality levels of partners it wishes to exchange information with, can often become specious and self-serving. If the Global Forum and OECD were indeed concerned with developing country interest beyond lip service, their evaluation of the level of data security infrastructure could have been considered adequate instead of imposing a second level of evaluation by individual countries.

Additionally, the leeway for countries to sign non-reciprocal treaties under automatic exchange, or for sharing CbCr, makes the underlying multilateral instrument facile. The "global" spirit of multilateralism demands that domestic laws of secrecy jurisdictions that are patently against international public good be identified and their removal sought. This includes, for example, the fetish of the Swiss government against use of "stolen" or whistleblower information when there is almost no other way for such information to see the light of day. The secrecy requirement, which would automatically be sidestepped if the data pertained to national security, should be similarly ignored for data on illicit financial flows which often has malignant links with money laundering, tax evasion and national security threats.

#### ***IV.4 Transparency standards unmatched to development levels***

When global standards of cooperation for information exchange are set at levels which exclude its benefits for the bottom of the pyramid, the quiet acquiescence by powerful emerging economies, including India, sends out signals that poor and developing countries have no one to speak for their exclusion. India's signing into the multilateral framework for CbCr with high thresholds, reciprocity and secrecy, instead of negotiating lower thresholds more meaningful to the size of its economy and the MNEs active in its jurisdiction, indicates the power of the OECD's siren songs. This is especially discouraging when international organizations have used the example of India's longstanding practice of corporate disclosure on subsidiary by subsidiary basis to debunk MNE arguments of loss of

competitiveness through public CbCr (Transparency International, 2016). India alone, as well as in alliance with its BRICS partners, commands the influence to modify OECD advisory models of transparency to align it with developing country interests. There is a need to call the bluff of MNEs who cite higher costs and protection of trade secrets to stymie tax transparency.

As an emerging economy with deep concerns for an efficient market mechanism it is in India's interest to demand public CbCr so that MNEs do not get their competitive advantage from complex and opaque tax structures instead of innovation driven efficiency and productivity. This is an important axis for alliance of developing countries, where support from civil society would be indispensable.

#### ***IV.5 Information use beyond tax purpose***

Information received through the automatic exchange mode of CRS and CbCr cannot be shared for purposes other than tax. This is a worrying prohibition considering that various financial crimes like money laundering, corruption and terror financing are found to have complex interlinkages with tax evasion and avoidance. Together, they threaten the strategic, economic and political integrity of countries, with disproportionate impact on fragile economies. A "whole of government" approach has been advocated for meeting these challenges through heightened cooperation between tax authorities and those dealing with other financial crimes, including money laundering (OECD, 2015B). The reluctance of OECD to frame its CRS and CbCr norms with such a "whole of government" approach enabling sharing across other government agencies, therefore, is inexplicable, if not hypocritical. Sustained pressure from developing country alliances as well as civil society seems to be the only way to build in such information sharing norms and expose the double speak of OECD.

#### ***IV.6 All together for financing SDGs***

The G20 directions for creation of a new global standard for exchange of information through automatic exchange has seen the light of day, all shortcomings notwithstanding. The responsibility for its effective implementation and robust functioning through international cooperation, however, still needs to be monitored. This acquires significance in the light of the G20 aligning itself with the 2030 Agenda

and the Sustainable Development Goals (SDGs) for which demands for additional funds are at an all-time high. The Hamburg Update<sup>28</sup> at the July 2017 summit of the G20 outlines collective goals across policy areas that promise to “further align” the group with the SDGs. The update refers to the Addis Ababa Action Agenda on Financing for Development which has recognized the centrality of taxes in the efforts of countries for financing development through Domestic Resource Mobilization.

Congruent with the above formal position, the G20 platform should be used to get all data on offshore assets of citizens/ residents of developing countries. Since there is universal consensus around the SDG goals the emerging economies in the G20 can leverage their membership to ensure that all secrecy jurisdictions, as well as all G20 countries, including affiliated jurisdictions such as the British Virgin Islands, should make disclosure of aggregate value of potentially reportable accounts held by residents of developing countries in their financial sectors. The Bank for International Settlements (BIS) holds a large part of this data but access to disaggregated country level data is not allowed. Such a disclosure would dilute the political opposition in many developing countries to tax reforms linked to greater efficiency through transparency.

## V. CONCLUSION

Transparency and disclosure through exchange of information, to enable countries to get their legitimate share of taxes, has undeniably moved up in the agenda of international tax cooperation. Whether bright sunlight now shines on dark secrecy jurisdictions, however, is still debatable. Rudolph Elmer, the whistle blower employee in the Swiss bank Julius Baer, who exposed the innards of the Swiss system used by ultra-high net worth individuals and multinational conglomerates to hide their income and evade taxes, believes that with the exchange of information networks not much has changed - “actually, the business of secrecy has become even more lucrative”.<sup>29</sup>

This chapter has discussed the lack of capacity of developing countries to individually challenge the complex and untouchable financial structures created for purposes of tax evasion. Strength through alliance remains the

<sup>28</sup> <http://www.g20.utoronto.ca/2017/2017-g20-hamburg-update.html>

<sup>29</sup> <https://thewire.in/164039/indian-politicians-swiss-bank/>



way out for them from the quagmire of an iniquitous and secrecy shrouded global financial architecture. The litmus test for stronger nations like India, or the BRICS grouping, will be their continuance of the struggle for an equitable international tax order even after they have been invited into the circle of the elite.

In the final analysis, however, only the inclusion of developing countries as equal partners in norm setting for international taxation, including sharing of information, can ensure equity and fairness in getting their share of tax. OECD's "inclusive framework" for implementation of BEPS Action Plans,<sup>30</sup> introduced in the face of criticisms about its unrepresentative character, has faced reluctance from many developing countries "as they were not part of the actual decision-making process during the BEPS project" (Johnston, 2016, p. 33). The proposal for up-gradation of the UN to an intergovernmental body with adequate resources has been persistently resisted by the OECD members, recently at the UN's 2015 Financing for Development (FfD) conference in Addis Ababa and later at the 14<sup>th</sup> session of the United Nations Conference on Trade and Development (UNCTAD) in Nairobi in July 2016. India has been a front ranking advocate for such up-gradation.<sup>31</sup> This resonated in its official response<sup>32</sup> to the Note Verbale 10/340 dated 1<sup>st</sup> December following the ECOSOC resolution 2010/33,<sup>33</sup> and was emphasized when it became the first country recently to make a voluntary contribution to the UN Tax Trust Fund that supports the Tax Committee.<sup>34</sup> Ecuador's persistent push to the agenda, as the current Chair of the Group of 77 and China (G-77), in various bold initiatives has kept the flame lit for this issue<sup>35</sup> and represents the way forward for developing countries seeking equity and just tax rules through the UN.

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<sup>30</sup> <http://www.oecd.org/tax/all-interested-countries-and-jurisdictions-to-be-invited-to-join-global-efforts-led-by-the-oecd-and-g20-to-close-international-tax-loopholes.htm>

<sup>31</sup> <http://www.un.org/esa/ffd/wp-content/uploads/2017/04/India.pdf>

<sup>32</sup> [http://www.un.org/esa/ffd/wp-content/uploads/2011/04/20110426\\_India.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2011/04/20110426_India.pdf)

<sup>33</sup> <http://www.un.org/esa/ffd/tax/documents/10-340nve.pdf>

<sup>34</sup> <https://www.un.org/development/desa/en/news/sustainable/addis-ababa-action-agenda.html>

<sup>35</sup> <https://thewire.in/103436/ecuador-revives-campaign-for-an-inter-governmental-un-tax-body/>

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# CHAPTER 7

## ILLICIT FINANCIAL FLOWS: CONCEPTUAL AND PRACTICAL ISSUES<sup>1</sup>

Irene Ovonji-Odida and Algresia Akwi-Ogojo

### I. INTRODUCTION

Neither the abolition of slavery nor the end of colonial rule over African countries has translated into economic affluence, prosperity or comfort for the majority of African citizens. African countries remain some of the poorest and least developed countries, despite owning huge natural resources and the youngest growing population in the world. As Bastian Obermayer and Frederik Obermaier note in their book,

“Africa is incredibly rich. Half the world’s diamond deposits are found on the African territory, along with a quarter of the world’s gold reserves, 10% of oil reserves and 9% of gas reserves. And there’s uranium, mineral ores, and much more. The population gets virtually nothing from it: the money simply disappears, into accounts of large multinational companies or safes of the elite.”<sup>2</sup>

Although African countries receive and benefit from official development assistance, the continent suffers and continues to suffer from a crisis of insufficient resources for development. Research<sup>3</sup> and reports<sup>4</sup> reveal the sheer scale and magnitude of illicit financial flows

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 6 (January 2019).

<sup>2</sup> Bastian Obermayer and Frederik Obermaier, *The Panama Papers: Breaking the story of how the rich & powerful hide their money* (London, Oneworld Publications Ltd., 2016).

<sup>3</sup> See for example, Nicholas Shaxson, *Treasure Islands: Tax Havens And The Men Who Stole The World* (London, Vintage Books, 2012).

<sup>4</sup> AU/ECA Conference of Ministers of Finance, Planning and Economic Development, *Track it! Stop it! Get it! Report of the High Level Panel on Illicit Financial Flows from Africa* (Addis Ababa, January 2015). Also referred to as the Mbeki Report.

from Africa that keeps African countries as some of the poorest and least developed countries in the world. The African Union (AU)/ United Nations Economic Commission for Africa (UNECA) High Level Panel (HLP) on Illicit Financial Flows (IFFs) from Africa (the Mbeki panel) established that Africa annually loses more than fifty billion dollars (\$50 billion) through illicit financial outflows.<sup>5</sup>

In this chapter we seek to show how the current political economy - its rules, systems, structures, culture and practices have not only created a world order that is not only regrettably skewed against African countries in favour of the richer, more developed Western economies but also enables, facilitates and supports the huge illicit financial flows out of Africa. The situation is made worse and debilitating because of the role of co-opted local elites including political leaders, the business class and technical experts as active participants or silent conspirators in managing, and maintaining this neo-liberal agenda. Nicholas Shaxson in his book *Treasure Islands*<sup>6</sup> reveals that “the African curve of the Atlantic Coastline supplies almost a sixth of US oil imports and about the same share of China’s and yet, beneath the veneer of great wealth lay terrible poverty, inequality and conflict”, intrinsically linked to “a system of corruption linking the French political and intelligence establishments, the French oil industry and Gabon’s corrupt ruler, Omar Bongo.”

There is a direct link between the seeming inability of African countries to overcome their development challenges and the current global political-economy that promotes illicit financial flows from Africa through sanitised and generally accepted principles, rules and/or practices for conducting world trade and business. The design and application of Double Taxation Treaties (DTTs); the operation of the international tax system; the systems of tax-cutting and financial deregulation; the existence of tax havens, offshore

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<sup>5</sup> Ibid., p. 2; SEATINI and ActionAid, *Double Taxation Treaties in Uganda: Impact and Policy Implications* (July 2014), p. 7. Available from <http://www.seatiniuganda.org/publications/research/72-double-taxation-treaties-in-uganda-1/file.html>;

Obermayer and Obermaier, *The Panama Papers*, p. 194.

<sup>6</sup> Shaxson, *Treasure Islands*, p. 1.



funds and accounts; the practices of corporate tax dodging; the half-hearted strategies aimed at addressing these injustices such as the Organisation for Economic Co-operation and Development (OECD) led investigation on the “base erosion and profit shifting” (BEPS) process; and the activities of Multi-National Corporations (MNCs); to name but a few, are some of the ways the globalisation project has been conceptualised to undermine any real chance for African countries to meet the United Nations (UN) Sustainable Developments Goals (SDGs) and targets.

Efforts to redress this situation remain futile to date. Hence, the importance of persistently flagging up the problem of illicit financial outflows from Africa and raising world consciousness to the injustices towards Africa.<sup>7</sup> As Tom Burgis states “*as ever, few have drawn the connection between these countries*” [read *African Countries*] *political upheavals and the global industries that feed on their natural resources. But some in the west seem to be awakening to the fact that corruption, like football and finance, has gone global.*”<sup>8</sup> In this chapter we share our understanding of the unjust system that drains billions of dollars out of the continent annually, and make recommendations and a case for bringing citizens back into the political economy discourse; and to reshape the rigged rules and systems into an effective framework for stemming the huge illicit financial flows from Africa to other regions.

## **II. BACKGROUND**

### ***II.1 Illicit Financial Flows from Africa and Why It Matters***

Illicit financial flows means money illegally earned, transferred or used i.e. illegal in origin, movement or use. This definition adopted by the Mbeki panel is shared by Global Financial Integrity (GFI), a Washington D.C. based research and advisory organisation.

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<sup>7</sup> Mbeki Report, p. 21.

<sup>8</sup> Tom Burgis, *The Looting Machine: War Lords, Tycoons, Smugglers, and the Systematic Theft of Africa's Wealth* (London, William Collins Books, 2015), p. 253.

According to the Mbeki panel report, this is to distinguish IFFs from capital flight, which is sometimes driven by macroeconomic and governance factors that may be entirely licit. The report of the High Level Panel notes that “this definition avoids complicated explanations of what qualifies as IFFs and debates about whether investors should be allowed to respond rationally to economic and political risk” and further that this definition addressed the “issue of IFFs across the entire breadth of financial transactions”.<sup>9</sup>

## ***II.2 Why the Global Focus on IFFs?***

For Africa alone the sheer scale and magnitude of IFFs are estimated to cost three to ten times official development assistance (ODA)<sup>10</sup> and the value lost is put at between USD 60 billion to 1 trillion annually,<sup>11</sup> up from USD 20 billion in 2001. Estimates show high flows from 33 African countries, amounting to \$353.5 billion between 2000 and 2010.<sup>12</sup> There is a disturbing trend indicating increased outflows annually. Other regions are affected too, including rich States like Ireland and Iceland. The European Parliament estimates that European Union (EU) governments lose up to €70bn (£56bn) a year through corporate tax avoidance.<sup>13</sup>

The Panama Papers (and recently Paradise Papers) exposés are the largest revelations to date exposing the dark secrets of how the

<sup>9</sup> Mbeki Report, p. 15.

<sup>10</sup> Angel Gurría, “The global dodgers”, *The Guardian*, 27 November 2008. Available from [www.theguardian.com/commentisfree/2008/nov/27/comment-aid-development-tax-havens](http://www.theguardian.com/commentisfree/2008/nov/27/comment-aid-development-tax-havens); ActionAid, *The BEPS process: failing to deliver for developing countries* (September 2014), p. 2. Available from <https://actionaid.org/publications/2014/beps-process-failing-deliver-poor-countries>.

<sup>11</sup> Mbeki report, p. 64.

<sup>12</sup> *Ibid.*, p. 33.

<sup>13</sup> European Parliamentary Research Service, *Bringing transparency, coordination and convergence to corporate tax policies in the European Union* (September 2015). Available from [https://www.europarl.europa.eu/RegData/etudes/STUD/2015/558773/EPRS\\_STU\(2015\)558773\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2015/558773/EPRS_STU(2015)558773_EN.pdf); European Parliament News, “Tax avoidance: MEPs accuse Council of undermining EU’s credibility”, 1 February 2018. Available from <https://www.europarl.europa.eu/news/en/headlines/economy/20180126STO94140/tax-avoidance-meps-accuse-council-of-undermining-eu-s-credibility>.

rich and MNCs avoid paying their share of taxes by hiding fortunes in offshore havens. According to these papers, corporations in “African states avoid paying about \$38 billion in taxes, because companies operating there divert their profits to tax havens”.<sup>14</sup> A statement attributed to Tom Burgis, a British author and Financial Times correspondent describes the situation thus – “an invisible machine is working to plunder the continent. A looting machine. A coalition of corrupt dictators, unscrupulous large corporations and ruthless banks, all working hand in hand, united in their greed”,<sup>15</sup> with shell companies often used by “autocrats and corrupt business people ... en masse in order to cover their tracks and to invest money abroad”.<sup>16</sup> The Panama exposé generated outrage around the world over how such nefarious practices, running through a network of secrecy jurisdictions, are rapidly widening economic inequality. These disclosures underscore the urgency of a global solution to this increasingly damaging global problem.<sup>17</sup>

Still, IFFs have a higher impact on poor, resource-rich countries in the global South due to the high dependence of their economies on natural resources and primary products, and the greater dependence on tax in comparison to developed economies.<sup>18</sup> Additionally the disproportionate impact on developing countries is because rich countries in the global North are often the destination for the funds lost<sup>19</sup> which thereby enter those economies. Growing social discontent and political unrest due to inequality of income, opportunity and futures is a reality of many in Africa. And yet for governments to be able to fund SDGs and deliver on their human rights obligations to provide public health care, education, water and sanitation, affordable

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<sup>14</sup> Obermayer and Obermaier, p. 194.

<sup>15</sup> *Ibid.*, p. 192.

<sup>16</sup> *Ibid.*

<sup>17</sup> *Ibid.*, p. 9; Global Alliance for Tax Justice, “The World needs a United Nations Global Tax Body now: The most equitable way to create a fairer global tax system”, New York, 18 April 2016. Available from [http://www.taxjustice.net/wp-content/uploads/2013/04/GATJ-statement-GlobalTaxBodyPanamaPapers\\_18Apr2016.pdf](http://www.taxjustice.net/wp-content/uploads/2013/04/GATJ-statement-GlobalTaxBodyPanamaPapers_18Apr2016.pdf).

<sup>18</sup> SEATINI and ActionAid, Double Taxation Treaties in Uganda, pp. 20, 23.

<sup>19</sup> OECD, *Illicit Financial Flows from Developing Countries: Measuring OECD Responses* (2014). Available from [http://www.oecd.org/corruption/Illicit\\_Financial\\_Flows\\_from\\_Developing\\_Countries.pdf](http://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf).

housing and transportation among others, all countries must take a concerted effort to curb these IFFs out of Africa. Tax evasion destroys trust in public institutions and the rule of law, and shrinks the fiscal space for investing in public services, social security and other goods and services. Public funds that are essential to guarantee economic, social economic and cultural rights to all are robbed from the people.

The increased focus on IFFs by governmental and other actors followed the realization of its staggering scale, at a time of economic pressure on many countries associated with the 2008 global financial crisis in Western countries. The scope of IFFs was flagged to African governments at an AU meeting of finance ministers in 2011, which resolved to set up a high level panel headed by H.E. Thabo Mbeki to investigate how to end IFFs from Africa and make recommendations to African governments.

### ***II.3 The High Level Panel on Illicit Financial Flows from Africa (Mbeki HLP)***

The HLP on IFFs from Africa was set up in February 2012 by the AU/ECA Ministers of Finance and Economic Development with specific Terms of Reference - to determine the nature and patterns of illicit financial outflows from Africa; establish the level of illicit financial outflows from the continent; assess the complex and long term implications of IFFs for development; sensitize stakeholders including governments and citizens; and make proposals to reverse it. It was chaired by H.E. Thabo Mbeki, former President of South Africa.<sup>20</sup>

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<sup>20</sup> The other Panel Members were Vice Chair: Mr. Carlos Lopes, Executive Secretary of the ECA; Mr. Olusegun Apata, retired Ambassador/Chair, Nigeria (Coca-Cola) Bottling Company; Mr. Raymond Baker, Director, Global Financial Integrity; Ms. Zeinab El-Bakri, former Vice President, African Development Bank; Mr. Abdoulaye Bio-Tchane, former Minister of Finance Benin & Africa Director, IMF; Mr. Henrik Harboe, Director, Development Policy, Ministry of Foreign Affairs, Norway; Mr. El Hadi Makboul, Secretary General, Ministry of Industrial Development & Investment Promotion, Algeria; Mr. Akere Muna, President of the Pan-African Lawyers Union/ Vice President, Transparency International and Ms. Irene Ovonji-Odida, International Board Chair, ActionAid International.

While exploring the policy dimensions of IFFs, the HLP adopted an approach that matched original research with advocacy and inclusive consultations. To this end the HLP commissioned a background paper to explore the nature, magnitude and development challenges of IFFs from Africa based on disparities in national income accounts and trade data and the extent to which financial secrecy among Africa's trade partners exposes African countries to risk of IFFs through trade mis-pricing or mis-invoicing. It conducted six country specific studies<sup>21</sup> and consultations with a wide cross-section of stakeholders in and outside Africa including policy makers, private sector and civic organizations alongside an advocacy and communication strategy to create awareness about IFFs and its impact on Africa.

#### ***II.4 Key Findings of UNECA High Level Panel on IFFs<sup>22</sup>***

- 1: Illicit financial flows from Africa are large and increasing
  - IFFs from Africa increased from about \$20 billion in 2001 to \$60 billion in 2010.
  - IFFs are estimated to be between 3 – 10 times ODA.<sup>23</sup>
  - This impacts on development including losses in tax revenue, savings and economic investment and undoes domestic resource mobilization capacity that would fill the declining ODA gap.
- 2: Ending illicit financial flows is a political issue
  - The political economy of IFFs is central to ending it – it is driven by highly powerful actors and interests, and has harmful governance effects. Political commitment is key for any action.
- 3: Transparency is key across all aspects of illicit financial flows
  - IFFs are enabled by financial secrecy jurisdictions; in-house trading by MNCs in which information on inputs, outputs, and services is often opaque.

<sup>21</sup> Algeria, Democratic Republic of Congo (DRC), Kenya, Liberia, Mozambique and Nigeria.

<sup>22</sup> Mbeki report, Chapter 4, pp. 63-76.

<sup>23</sup> As per OECD and Tax Justice Network, as cited in Mbeki report, *ibid.*, p. 64.

- Transparency in financial reporting requires reforms such as country-by-country account of sales, profits and taxes paid by MNCs; declaration of beneficial ownership in commercial entities, including banking and securities accounts; and cross-border exchange of tax information to cut down aggressive tax avoidance or evasion.

4: Commercial routes of illicit financial flows need closer monitoring

- Commercial drivers of IFFs cause two thirds of losses. They include under-declaration of exported oil, gas, minerals, and agricultural products such as timber and fish. But there is no global regime for commercial IFFs drivers.

5: The dependence of African countries on natural resources extraction makes them vulnerable to illicit financial flows

- The extractives sector is a major area of IFFs. Poorly structured natural resource extraction contracts are used to reduce or eliminate legitimate earnings from royalties or tax.

6: New and innovative means of generating illicit financial flows are emerging

- These bring new twists to the issue, increasing challenges in stopping it.

7: Tax incentives are not usually guided by cost-benefit analyses

- Corruption is a key driver of tax incentives like tax holidays. Studies show no relation between foreign direct investment (FDI) and tax incentives. Real decisions on FDI are influenced by political stability, cost of doing business like energy, infrastructure and labour. MNC tax abuse burdens smaller domestic firms, yet small and medium-sized enterprises (SMEs) contribute more to employment than MNCs.

8: Corruption and abuse of entrusted power remains a continuing concern

- IFFs undermine state institutions, rule of law and state capacities, affecting public confidence and diverting public money to private uses.
- IFFs skew income distribution and are linked to inequality.

9: More effort is needed in asset recovery and repatriation

- IFFs primarily go to external destinations such as tax havens. These are both traditional and new destinations.
- The Tunisian experience post-Middle East and North Africa (MENA) uprising illustrates the role of banks, accounting firms, and lawyers in supporting and enabling MNC practices and outdoing government capacities.

10: Money laundering continues to require attention

- Harmonization of laws on anti-money laundering is required to address criminal acts. MNCs misprice imports & exports to avoid duties or transfer monies, especially foreign exchange out of African countries. Liberia's situation on this is worsened by having USD as legal tender.
- Policies such as de-regulation and liberalization reduce ability of governments to stem money laundering.

11: Weak national and regional capacities impede efforts to curb IFFs

- IFFs reduce capacity of African governments to give essential public services such as health, education and to invest in physical infrastructure. IFFs have a direct human cost especially on the most vulnerable citizens.
- IFFs weaken the financial sector, tax collection, market regulation and integrity of public financial systems, stability and security. Liberalized and de-regulated economies enable IFFs by cutting regulatory capacity of key agencies such as customs.

- Government technical capacity is often insufficient to prevent trade mispricing; support negotiation of good contracts in the extractive sectors, and to monitor resource exploitation.
- Strong negotiating capacity is necessary to shape the emerging global architecture.
- Within Africa as a region, the African Tax Administration Forum (ATAF) has initiatives relevant for capacity building.

12: The global architecture for tackling illicit financial flows in incomplete

- The global architecture is uneven. There are adequate global frameworks on government corruption and criminal activities like money laundering, but not on IFFs from commercial activities.

13: Financial secrecy jurisdictions must come under closer scrutiny

- Transparency, uncovering secrecy and obtaining information, collaboration, cooperation, are key challenges.
- Tax havens and financial secrecy jurisdictions enable easy registration of corporate special purpose vehicles and nominal owners that mask beneficial owners.

14: Development partners have an important role in curbing IFFs

- There are recent initiatives like the Oslo Dialogue on government approach to fighting tax crimes; OECD backed “Tax Inspectors without Borders” and the BEPS process. But many of these initiatives are not universally applicable or address IFFs from Africa. OECD BEPS agreement omitted major concerns from Africa.



- The cooperation of OECD, the Group of Eight (G8) and Group of Twenty (G20), where most economically powerful states belong and are destination countries is critical to close gaps in global governance on factors enabling IFFs.

15: IFF issues should be incorporated and better coordinated across United Nations processes and frameworks

- The UN should align and prioritize regulation of commercial transactions especially by MNCs and include African IFFs in key global processes like UN post-2015 Development Agenda and the Financing for Development process

(summary of findings from Mbeki report on IFFs from Africa)

### III. CONCEPTUALISING IFFs

Illicit financial flows are defined as *money illegally earned, transferred or used, i.e. illegal in origin, movement or use*. IFFs are the most damaging economic problem faced by the developing and emerging economies as trillions of dollars required in order to reach the SDGs are siphoned off.

#### III.1 *Modalities Used in IFFs*

The role of multinational enterprises has been identified as a major driver of practices that undermine a fair system. The Mbeki report shows that two-thirds of IFFs (65%) are due to practices of MNCs with trade mis-invoicing as the largest single source. Use of intragroup loans, DTTs, intellectual property rights (IPRs), management fees, unequal contracts, banking secrecy to abet IFFs, evade tax and other dues to States are some of the MNCs' practices.<sup>24</sup>

#### III.2 *Sources of IFFs*

- Two thirds of the problem: Commercial transactions – 65% IFFs

The Mbeki panel<sup>25</sup> paid significant attention to commercial drivers of IFFs due to its disproportionate scope on the one hand *vis-à-vis* the other two, and the inadequate focus on it in comparison to

<sup>24</sup> Ibid., pp. 79-86.

<sup>25</sup> Ibid., Chapter 2.

criminal acts and government corruption. The insufficient focus on commercial drivers of IFFs is reflected in the near-invisibility in the public narrative of the complicity of corporate actors in driving IFFs and inadequate development of legal tools to fight it. At international, regional and national levels more instruments have been developed to fight government corruption such as the UN Convention against Corruption and the AU Convention on Preventing and Combating Corruption and to address criminal acts like money laundering, largely due to its link to terrorism rather than to regulate commercial transactions that support IFFs. Attempts to develop binding legal instruments to regulate corporate activities and increase transparency have consistently been met with strong lobbying and watered down to voluntary guidelines.<sup>26</sup> Given that “*IFFs often leave developing countries through the commercial financial system*”<sup>27</sup> there is need for a spotlight on commercial drivers of IFFs and the role of major banks and financial centres including extraterritorially.

Small and medium scale enterprises typically use mis-invoicing of imports and exports<sup>28</sup> to evade taxes.<sup>29</sup> However, most commercial mechanisms for IFFs lend themselves more to application by MNCs due to their multi-jurisdictional presence and ability to exploit loopholes and divergence in global, regional and national financial rules on double taxation and banking using intra-house trade and special purpose vehicles like shell corporations.<sup>30</sup>

*“By using complicated tax arrangements, some multinationals can pay nearly a third less tax than companies that only operate in one country. It’s*

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<sup>26</sup> Some of the measures that have been effectively watered down include UN Guiding Principles on Business and Human Rights, and EU-proposed measures for country-by-country reporting by large companies and to deal with tax havens and financial secrecy jurisdictions. Repeated attempts by the AU, African Tax Administration Forum (ATAF) and various non-governmental organizations (NGOs) to have the OECD BEPS process include non-OECD countries and issues were not very successful. The lack of political support of rich governments for a UN DTT model and a democratic, UN-led process to reform the international tax system reflect the same bias.

<sup>27</sup> OECD report, *Illicit Financial Flows from Developing Countries*, p. 11.

<sup>28</sup> Mbeki report, p. 28.

<sup>29</sup> *Ibid.*, p. 37.

<sup>30</sup> Obermayer and Obermaier, Chapter 1, pp. 10-38; Burgis, *The Looting Machine*; Mbeki report, *ibid.*, p. 37.

*not right that smaller companies should be at a competitive disadvantage to multinationals.”* (Jonathan Hill, EU commissioner for financial services)<sup>31</sup>

Even advanced economies face challenges tracking the tax dues of MNCs due to lack of country-by-country reporting on profits, taxes, employees, and turnover, leading the EU to push for more transparency and closer regulation of multinational operations with turnover greater than €750m and the OECD to set up a process to curb BEPS activities within its member states.

The Mbeki report and other sources<sup>32</sup> highlight several cases through which commercial IFFs were found to take place in Africa –

- Tom Burgis in his book noted the smuggling of goods ranging from guns to counterfeit products from mostly China across west African countries of Benin, Nigeria to Niger, among others;<sup>33</sup>
- Abuse of tax holidays for new foreign investors by hotels in Tanzania through periodic false ownership change, cited in regional consultation for East and Southern Africa of Mbeki panel;
- Unequal concessionary contracts in the mining sector (Guinea);<sup>34</sup>
- Arms smuggling and instigation of armed conflict between war lords to avoid government regulation and taxation (DRC) (cited by women from eastern DRC in meeting on Transitional Justice).<sup>35</sup>

Nicholas Shaxson (2012) writes that by the early 1980s,

*“the main elements of the modern offshore system were in place and ... while the old European havens were mostly about secret wealth management and tax evasion, the new British and American zones are mostly about escaping financial regulation with a lot of tax evasion and criminal activity thrown in”.*<sup>36</sup>

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<sup>31</sup> Jennifer Rankin, “Europe pressures multinationals to declare taxes and profits”, *The Guardian*, 12 April 2016. Available from <https://www.theguardian.com/business/2016/apr/12/brussels-pressures-multinationals-to-declare-taxes-and-profits>.

<sup>32</sup> Mbeki report, Chapter 2.

<sup>33</sup> Burgis, pp. 61-79.

<sup>34</sup> Ibid.

<sup>35</sup> Also cited in Burgis, *ibid.*

<sup>36</sup> *Ibid.*, p. 147.

- Criminal drivers of IFFs

The second largest source of IFFs is criminal transactions such as money laundering, smuggling and trafficking in humans, drugs and arms. About 30% of IFFs are traced to criminal transactions. While some of the proceeds of criminal IFFs exit through overtly illegal means such as smuggling, a significant proportion is extracted using the same loopholes exploited by commercial IFFs such as rules allowing opaque banking transactions, tax havens and financial secrecy jurisdictions.

- Government corruption

Corruption by government officials contributes 5% of IFFs from acts such as bribery, theft of state assets and abuse of office. However, the acts of government officials are an enabling factor in both commercial and criminal drivers of IFFs, contributing to weak state regulation of business malpractice, unfair concessionary agreements obtained through collusion or aiding and abetting smuggling and trafficking rings by law enforcement, revenue and custom agents. Overall, official corruption by government officials weakens the ability and commitment of the state to fight and contributes to a governance environment conducive to continued outflows.

#### **IV. ECONOMIC GROWTH VERSUS DEVELOPMENT: AN IDEOLOGICAL CONCEPT AND CONSTRUCT**

The failures of the current financial system and dominant model of development are self-evident. There are several crises threatening the world's political economy today generated by current global financial rules and systems. For serious reform to happen addressing structural issues, an ideological shift is needed away from the mantra about "*growth*" to the concept of development. The "*growth*" approach to measuring progress is hinged on the neoliberal ideology which through its main pillars of privatisation, liberalisation and de-regulation systematically dismantled the role of the developmental State in promoting inclusive development.

Various authors have sought to shed light on the dominant political order.<sup>37</sup> There are some common threads that run through these exposés

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<sup>37</sup> Obermayer and Obermaier; Burgis, *ibid.*; Shaxson; Naomi Klein, *The Shock Doctrine: The Rise of Disaster Capitalism* (Knopf Canada, 2007), pp. 3-21.

and which are pertinent to appreciating IFFs. One is that there is a shadow world in which “normal rules” regulating the 99% do not apply to the elite, but are reversed, whether on tax justice, transparency in business, criminal accountability, rule of law, *even norms on shame and stigma*. The privileged world of the powerful political and economic elite (primarily from richer nations with subordinated local collaborators from the global South) is a bubble separating and protecting this minority from the rest.

These opaque systems and power relationships are replicated within and between states, in areas ranging from financial, taxation, banking, accounting, law, primarily in matters business and economic that rig key rules or outcomes, for example, on double taxation, in favour of the powerful and wealthy.<sup>38</sup> Global, regional and national financial rules are gamed to favour the wealthy, for example there is often pressure on developing States to apply OECD as opposed to the UN double taxation model; yet the latter based on source of profit is more beneficial than the former based on residence of the corporate entity.<sup>39</sup> Continued protection of banking and financial secrecy of tax havens and offshore businesses reflect this shadow system.

Unwritten rules extend this world to the political and economic spheres creating a nexus between privileged political, economic and social elites, with subtle blurring of principles and a dominant narrative presenting abusive privilege and practice as normal, smart and licit. Fighting this opaque, shadowy system is challenging and dangerous, with those who fight it branded and immense resources made available for supporters of this global regime from States and corporations.

Perhaps the biggest success of the neoliberal system has been conceptual, the successful rebranding of “growth” as development and entrenchment of its ideological pillars in the strategic centres of decision making in state and global institutions, in the realms of finance, trade and aid.

Every political economy generates its norms, values, orientation and practices. A presentation on the neoliberal moral economy

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<sup>38</sup> Shaxson, pp. 1-7; Oxfam, *Rigged Rules and Double Standards – Trade, globalisation and the fight against poverty* (2002). Available from <https://policy-practice.oxfam.org.uk/publications/rigged-rules-and-double-standards-trade-globalisation-and-the-fight-against-pov-112391>.

<sup>39</sup> SEATINI and ActionAid.

in Uganda that explores capitalism, socio-cultural change and fraud<sup>40</sup> stated that the very fabric of society and specifically values and practices in economics and politics has been re-aligned to the dominant norms and values of a market society; this has transformed Ugandan society and culture, towards “*materialism, self-interest, opportunism, short-termism and corresponding relatively low regards for both others and the common good*”. It reflects a global trend since the 2000s in which neoliberalism has engineered moral restructuring of societies resulting in “... *the new age of fraud where economic deception has become a structural feature of the global economy and an issue of concern in many societies*”.

The effect on elected representatives of the people is to create an invisible constituency that trumps voters and skews even constructive initiatives aimed at reducing inequality: the development agenda in the World Trade Organization (WTO), Financing for Development, the UN SDGs, and the OECD BEPS process. The inconsistency in rules is seen in deregulation of big business as contrasted with increased restrictions on labour and citizens through public order laws, a phenomenon described increasingly as shrinking space for citizens.

The application of neoliberal macro-economic policies through the International Monetary Fund (IMF) and World Bank (WB)-recommended structural adjustment programs (SAPs) in Uganda from the second half of the 1980s to date has led to reversals in all key human/sustainable development indicators.<sup>41</sup> The mode of implementation, for example, in the privatization of state assets was highly irregular and corrupt, resulting in stripping of public assets by political and business elites and downsizing of public services on which the poor and middle class relied. The effect of so-called market led growth has been growing inequality and growth without inclusive development.<sup>42</sup> De-regulation led to the shrinking of state regulatory structures, particularly those protecting labour and social services; introduction

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<sup>40</sup> The presenter Jorge Wiegatz is conducting a study on the neoliberal moral economy in Uganda for an upcoming book.

<sup>41</sup> Oxfam, “An Economy for the 1%: How Privilege and Power in the Economy Drive Extreme Inequality and How This Can Be Stopped,” Oxfam 210 Briefing Paper (18 January 2016), p. 16. Available from <https://oxf.am/2FKbYYL>.

<sup>42</sup> Ibid.

of so-called market and investor-friendly policies has further tilted the balance towards powerful commercial actors – often fused with political elites - and fragmented the organizing and bargaining power of citizens. Anti-poor state policies and practices have often brutally suppressed and led to the demise of citizen-organizing through people’s organizations<sup>43</sup> - cooperatives, trade unions, professional and trade associations and the like. The outcome of the neo-liberal political economy has been State capture, progressive gutting of State capacity, reduction in the will to regulate powerful individuals and corporations, and proliferation of all three forms of IFFs.

IFFs are enabled by the neo-liberal policies of privatization, liberalization and de-regulation and the imposition of aid conditionalities to access international concessionary financing. Studies show that the neoliberal model has transformed economies and deepened inequality within and between countries and regions, with the rich getting richer and the poor, poorer.<sup>44</sup> The effect of neo-liberalism, the latest face of globalization in Africa is the paradox of a highly endowed continent, rich in resources with a largely impoverished population underperforming against all sustainable development indicators. Part of the explanation rests in illicit financial flows and the rigged rules and structural drivers of inequality rooted in the global political economy that enables it. MNCs have been identified as a major driver of practices that undermine a fair system.

The outcome of this growing inequality is an explosion of citizens’ disaffection particularly over the inability of political systems to level the ground. Pushed to the wall, citizens of poor, developing and developed nations are increasingly targeting their frustrations on governments as other available avenues for organizing close off. Loss of faith in the elected politicians’ commitment to represent majority citizens’ interests against elite minorities underlie recent outpouring of people power such as the

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<sup>43</sup> Issa G. Shivji, “Reflections on NGOs in Tanzania: what we are, what we are not, and what we ought to be”, Keynote address at the Gender Festival organised by the Tanzania Gender Networking Group; in *Development in Practice*, Volume 14 Number 5, August 2004. Available from <https://doi.org/10.1080/0961452042000239832>.

<sup>44</sup> Klein, The Shock Doctrine, p.10; Oxfam, “Methodology Note for Oxfam’s 2017 Report: “An economy for the 99%”,” Oxfam Technical Briefing, January 2017. Available from [www.oxfam.org/en/research/economy-99](http://www.oxfam.org/en/research/economy-99). See also Burgis, p. 3.

Arab awakening in the MENA region, Fees must fall campaign and Marikana incident in South Africa, Black Monday movement in Uganda, Occupy movement in several western states and even growing populist nationalism in richer countries as seen in Brexit in the UK and rejection of many mainstream politicians and parties in the USA, western Europe and India.

### **Legal and competency gaps**

IFFs is a complex, highly technical issue and requires a range of tools and knowledge from a range of disciplines such as law, finance, revenue and accounting to comprehend. Though topical today, IFFs are not widely understood by legislators, technocrats in revenue services, customs and law enforcement officials, judicial officers and various professionals including lawyers, accountants, journalists and bankers. Few development actors have the expertise to address it; neither do ordinary citizens. And yet there is already significant technical expertise and knowledge on matters of taxation, finance and law within African actors, both state and non-state. This presents opportunities to effectively address and end IFFs from multidisciplinary angles.

Interestingly, the nexus between powerful economic and political elites that facilitate and grow from IFFs also lend themselves to criminals and to links between organized crime networks, big business and political officials.<sup>45</sup> Ending this network of powerful vested interests and dismantling the political economy of IFFs is a high stakes game.

### **V. IFFs DEVELOPMENT COST**

IFFs are a human rights issue, undermining *inter alia* the right to development. IFFs' development cost is compounded by low asset recovery and slow repatriation of funds lost, due to intransigence of receiver states, banks and individuals. IFFs have been linked to human rights abuse associated with conflict minerals in a range of cases in several African states from Angola, Algeria, DRC, Guinea, Liberia, Nigeria, Sierra Leone, Uganda, and South Africa to Zimbabwe.<sup>46</sup> The same pattern holds in other regions from Latin America to the Middle East, Eastern Europe and even North America.

<sup>45</sup> Shaxson, p. 147; Obermayer and Obermaier, pp. 67 – 69. See also Klein, p. 15.

<sup>46</sup> Burgis, pp. 1-8.



IFFs challenge the concept of sustainable development and protection of the common wealth. They cohere to the exclusionary, individualistic and extractive neo-liberal economic model which is causing huge, inadequately compensated losses to countries and communities for natural resources like oil, gas, minerals, and agricultural products like timber and fish.<sup>47</sup> IFFs perpetuate income inequality between countries and between the rich and the rest.

A 2013 GFI study<sup>48</sup> found that IFFs surged to US\$ 1.1 trillion in 2013, with \$7.8 trillion cumulatively from 2004 to 2013 coming from developing economies. The study found that trade fraud is responsible for \$6.5 trillion of the illicit outflows; that IFFs average 4% of the developing world's gross domestic product (GDP), with sub-Saharan Africa still suffering the largest illicit outflows as a percentage of GDP, at 6.1%. Further, in seven of the ten years studied, global IFFs outpaced the total value of all foreign aid and FDI flowing into poor nations.<sup>49</sup> As the GFI report, and indeed others, underscore, IFFs are a growing global problem impacting countries in the global south and north, and both poor and rich countries, but with disproportionate impact on developing and emerging economies due to a variety of factors.

IFFs undermine the role of the state as a development actor, causing huge tax revenue losses and lowering domestic resource mobilization (DRM) in both developing and now-rich states. The threat posed by IFFs to achieving DRM and the SDGs is reflected in goal 16.4 of the SDGs which specifically calls on countries to reduce IFFs by 2030. Developing countries' ability to achieve a stable tax base is significantly undermined by IFFs.<sup>50</sup> The OECD conservatively estimates that 4 - 10% of global corporate income

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<sup>47</sup> Mbeki report.

<sup>48</sup> Joseph Spanjers and Matthew Salomon, *Illicit Financial Flows to and from Developing Countries: 2005-2014*, (Global Financial Integrity (GFI), 2017). Available from [www.gfintegrity.org/report/illicit-financial-flows-to-and-from-developing-countries-2005-2014/](http://www.gfintegrity.org/report/illicit-financial-flows-to-and-from-developing-countries-2005-2014/).

<sup>49</sup> Ibid. The data on IFFs as a % of GDP for other regions is: developing Europe: 5.9%, Asia: 3.8%, Western hemisphere: 3.6%, MENA + AP: 2.3%.

<sup>50</sup> Dr. Nara Monkam, ATAF, "Ensuring a sound tax base in developing countries: Are the current international initiatives sufficient?", 2 July 2015. Available from <http://effectivecooperation.org/wp-content/uploads/2015/07/Nara-Monkam-ATAF.pdf>.

tax revenues are lost due to BEPS, costing the world economy hundreds of billions of dollars a year.<sup>51</sup> Despite evidence that tax competition and incentives are not evidence-based,<sup>52</sup> governments desperate for foreign investment cede regulatory control and power to large corporations, who then maximize profits and do not meet their fair share of responsibility to the economy, placing an unfair tax burden on small and medium enterprises and citizens. Failure of large commercial entities and rich individuals to meet their fair tax burden and their illicit transfer of their profits and wealth through IFFs unfairly shifts the tax burden to smaller economic actors and ordinary citizens.

The EU Commission estimates that multinationals pay up to 30% less tax in the EU than rival companies which do not operate across border.<sup>53</sup> Differences in income and corporate tax rates further increase the income gap. Data analysed by Reuter<sup>54</sup> showed that five of the world's largest investment banks, including Bank of America and Deutsche Bank, paid no corporation tax in the UK in 2014.

IFFs are a governance issue, contributing to increased systemic crimes and development of crime syndicates of corporations and corrupt officials including elected representatives.<sup>55</sup> Proliferation of practices such as under-declared exports, smuggling, and unequal contracts eventually lead to state capture, abuse of power and predator states. This is seen in the effective lobbying by powerful corporations and their associations, like the US National Association of Manufacturers against proposed EU reforms of financial rules

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<sup>51</sup> OECD, "Reforms to the international tax system for curbing avoidance by multinational enterprises," Presentation of outputs of OECD/G20 BEPS Project for discussion at G20 Finance Ministers meeting, 5 October 2015. Available from [www.oecd.org/ctp/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm](http://www.oecd.org/ctp/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm).

<sup>52</sup> ActionAid, *The BEPS process*.

<sup>53</sup> EU Commission, Speech by Commissioner Pierre Moscovici at the Tax Congress of the Berlin Tax Forum 2016, Berlin, 20 June 2016.

<sup>54</sup> Peter Reuter, "Illicit Financial Flows and Governance: The Importance of Disaggregation", World Development Report Background Paper (Washington, D.C., World Bank, 2017). Available from <https://openknowledge.worldbank.org/handle/10986/26210>.

<sup>55</sup> Shaxson, p. 149.

such as new public reporting standards requiring country-by-country breakdown of profits made, taxes paid, employees and turnover in all EU countries and tax havens.<sup>56</sup> Involvement of key professions like lawyers, bankers and accountants in enabling commercial IFFs represents an existential threat to the rule of law and democracy. Many developing country governments cannot match the technical capacity of these hired hands in negotiations or legal suits involving multinationals.

IFFs incentivize opacity in financial transactions through growth of tax havens and financial secrecy jurisdictions, and use of mechanisms such as special purpose vehicles. They have driven harmful global financial policies and due to the fierce lobbying of vested corporate and rich-State interests, have subordinated the international and democratic rule-making role of the UN in taxation, development, trade, among others. In this situation, international rule-making is increasingly corporate-driven in spaces like the OECD and international financial institutions (IFIs), which are dominated by rich countries, resulting in uneven rules that do not balance the interests of all countries.<sup>57</sup> Rich countries and international power centres like IFIs and the OECD should support international cooperation in international norm setting and respect rules and practices that create equality of decision making in multilateral spaces. The central role of multilateral institutions under the UN system in development of global norms and new rules on taxation and trade among others is critical and is in the global interest.

## **VI. ENDING IFFs: FROM RHETORIC TO PRACTICAL STEPS**

The Mbeki report made several recommendations addressing the commercial, criminal and corruption components of illicit flows; these include recommendations to criminalize trade mispricing

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<sup>56</sup> *Ibid.*, pp. 147 – 165; Klein.

<sup>57</sup> First Subregional Workshop on Curbing Illicit Financial Flows from Africa Meeting Report (14-15 September 2015, Nairobi, Kenya). Available from <http://iffodatabase.trustafrica.org/iff/Meeting%20Report%20First%20Subregional%20Wshop%20on%20IFFs%20Sept%202015%20Nairobi%20September%202015.pdf>.

through strengthened regulation and taxation of corporate entities and transparency and exchange of information on trade transactions data and measures to curb transfer pricing such as investing in institutional capacity of revenue agencies.

In summary, the recommendations indicate the need for governments, intergovernmental bodies and regional blocs to institute measures to:

1. Improve governance and accountability to all citizens, for example, ending opaque and deliberately badly structured resource extraction contracts that deny African countries legitimate earnings from royalties or tax;
2. Strengthen regulatory capacities including resourcing of tax, customs, immigration, and other administrations, to end practices like under declaration of quantities of exported goods;
3. Promote global cooperation and transparency to stop aggressive tax avoidance and trade mispricing in trade imports and exports through cross-border exchange of tax information, country-by-country account of sales of, profits of and taxes paid by multinational corporations, declaration of beneficial ownership in commercial entities, including banking and securities accounts;
4. Support international cooperation in regulatory law reform and systems such as harmonizing anti-money laundering laws and DTTs to avoid double *non*-taxation; and
5. OECD governments must sign up to more measures against tax avoidance, support efforts by African governments to enforce compliance by corporations and make the BEPS process work for developing countries too. The OECD's failure to fully include countries from the developing world in the BEPS negotiations, despite requests from the Mbeki HLP and ATAF among others is a lost opportunity.

Clearly, actions to end IFFs must happen at multiple levels from national, regional to global, take place on many fronts and involve a range of actors.

As IFFs are a technical, complex issue, stopping them requires effective regulatory responses to create the necessary legal frameworks in countries and binding regional and international rules to close loopholes in revenue, banking, accounting, trade, customs, investment and IPR laws *inter alia* that enable particularly commercial-based IFFs. These should extend to regulations governing key professionals such as lawyers, bankers and accountants that play a central role in facilitating such transactions and economic sectors particularly prone to IFFs. Critical traditional and emerging sectors are affected by IFFs. These include extractive industries, the financial sector (banking and insurance), e-commerce, telecommunications, tourism, gaming, and industry intangibles like IPR, brands and sales of companies.<sup>58</sup> Agricultural products and natural resources such as fisheries, rubber and timber are also impacted.<sup>59</sup>

Strengthening regulatory capacity requires investment by governments in institutional reforms where relevant and training for customs, revenue, finance, law enforcement and judicial agencies. However, the key gap is political commitment and leadership to prioritize and finance reforms, and to strengthen government institutions and machinery for tax administration, contract negotiation, and investment and trade-related financial leakages. In unanimously adopting the Mbeki report, AU member states pledged national and coordinated continental action.

The key message of the Mbeki HLP is that ultimately ending IFF is political, owing to the elite-power nexus on which IFFs thrive and power of economic and political actors IFFs benefit. Thus it requires high political commitment, for example, to close legal loopholes that enable exploitation of financial instruments by MNCs; to support tax administrations like the Internal Revenue Service (IRS) and Her Majesty's Revenue and Customs (HMRC) to close the tax gaps in the USA and UK respectively with regard to corporate tax payments; and to establish an equally robust global architecture for commercial IFFs as for corruption and criminal IFFs.

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<sup>58</sup> Mbeki report, Chapter 4.

<sup>59</sup> Ibid.

There is a consensus that IFFs are enabled by opacity in financial and other practices and rules that allow this lack of transparency. Ending IFFs requires significant focus on MNCs which have been implicated in base erosion practices that shift profits across borders to take advantage of tax rates that are lower than in the country where the profit is made through mechanisms like hybrid mismatches, special purpose entities (SPEs), and transfer pricing. Political will is essential for governments to introduce and enforce transparency in transactions and end financial secrecy by corporations and governments in trade and tax. Establishing measures to end financial secrecy jurisdictions and tax havens requires powerful champions within governments and intergovernmental bodies like the OECD and World Bank to overcome vested interests that continue to undermine reform efforts. The World Bank can easily develop an annual indicator of trade mis-invoicing from data governments already provide to the IMF and UN. It will take genuine, courageous leadership to achieve reforms such as public, disaggregated country-by-country reporting of financial information on multinational corporations by country of origin; harmonization of anti-money laundering laws, and double taxation treaties to avoid double *non-taxation*.

IFIs can advance international cooperation and inclusion in development of new rules to govern all States. Support from IFIs, the OECD and the EU Parliament for the central role of multilateral institutions under the UN system in development of global norms and new rules on taxation and trade, and equality of decision making in multilateral spaces would go a long way to strengthen democratic, inclusive international norm-making.

## VII. CONCLUSION

There are real opportunities for the world community to end IFFs. The Seventh Joint Annual Meeting of the ECA Conference of African Ministers of Finance, Planning and Economic Development and African Union Conference of Ministers of Economy and Finance in March in 2014 in Abuja issued a Ministerial Statement pledging to

“21. ...take the necessary coordinated action nationally, regionally and continentally to strengthen our economic governance institutions

and machinery, focusing especially on tax administration, contract negotiations and trade-related financial leakages. (And) ...engage with the international community, ... on the reform of global economic governance, ...to highlight our concerns regarding illicit transfers, including the question of tax havens.”

The adoption of the Mbeki report by the AU Summit in 2015 is only the first step for African governments towards practical action to fight IFFs.<sup>60</sup> This has been matched by action by civil society organizations (CSOs) on the issue. Many CSOs including the Tax Justice Network, ActionAid International, the Southern and Eastern Africa Trade Information and Negotiations Institute (SEATINI), Oxfam are campaigning in many countries for tax justice e.g. “Stop the bleeding” campaign; some women organizations are part of these networks.

ATAF has made some significant contributions. It identified base eroding issues of high priority to African countries not included in the BEPS Action Plan and led in defining AU states’ positions and responses e.g. formulation of new standards in commodity pricing, revisions to Chapter 1, interest deductibility, permanent establishment (PE) status, exchange of information and other aspects of international tax issues.<sup>61</sup>

Some professions such as lawyers under the Pan African Lawyers Union (PALU), various judiciaries, customs and revenue agencies have taken steps to build capacity of key professions.

IFFs are not Africa’s problem alone but a growing global threat to human development. Non-African governments have a crucial role to play in stemming them: they can ensure that their jurisdictions are not used as conduits or destinations, support a global norm against IFFs and support existing capacities in African countries to end IFFs. Countries can lead by example and take measures that encourage the transparency and simplicity required to have effective tax systems globally.

Overcoming vested interests of corporates and governments requires an alliance of engaged – and enraged - citizens in both the

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<sup>60</sup> Ibid., p. 20.

<sup>61</sup> Dr. Monkam, ATAF, “Ensuring a sound tax base in developing countries”.

global south and north. Trade unions, students, the youth, women's groups and civil society should be involved to play active parts in reclaiming and taking back control and decision making from the corporate in matters critical to their livelihoods and human development.

The role of parliaments, non-governmental organizations (NGOs), academia, media and social justice movements is central to simplifying the complex technicalities around IFFs so that citizens impacted by it can understand, mobilize and organize to challenge the drivers of inequality and rigged rules within and between countries. Within countries, lobbying will be needed to achieve political commitment for reform of regulatory and supervisory regimes in both north and south.

Further, global citizens' coalitions will need to pressure governments to realize international cooperation in reform of international rules such as on double taxation treaties. The role of intelligentsia, media and NGOs in exposing and unpacking the practices, false narrative and neoliberal ideological environment underpinning IFFs is equally core. These need to build a grand coalition of social justice actors and peoples' organizations including labour, women, youth, landless movements, anti-corruption activists, media, NGOs, elected politicians and academia to challenge powerful vested interests of corporates and political elite to finally cause change.



# CHAPTER 8

## THE DEFINITION AND TREATMENT OF TAX HAVENS IN BRAZILIAN TAX LAW BETWEEN 1995 AND 2015<sup>1</sup>

Alexandre Akio Lage Martins

### I. PROBLEM DEFINITION

Although “tax havens” and “tax havens lists” are terms often used by general and specialized media, it seems that little attention is paid to the fact that the definition of a tax haven and the purpose of a tax haven list may vary greatly from country to country.

For instance, the Organisation for Economic Cooperation and Development (OECD) has recently published its updated list of uncooperative tax havens. The *OECD Secretary-General Report to G20 Leaders*,<sup>2</sup> dated July 2017, states that:

*“Because of the perspective of the G20’s call to identify non-cooperative jurisdictions on the tax transparency standards, jurisdictions have moved fast to meet the objective criteria: 31 have signed (or asked to sign) the multilateral Convention on Mutual Administrative Assistance in Tax Matters, 101 have committed to commencing automatic exchanges of financial account information in 2017 and 2018 (all requested jurisdictions have now committed), and 17 jurisdictions have improved their Global Forum rating on the EOIR standard, so that only one (Trinidad and Tobago) remains “Non-Compliant”.”*

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 5 (December 2018).

<sup>2</sup> Available from <http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-leaders-july-2017.pdf>.

The OECD's list featured only one country and had its usefulness criticized.<sup>3,4</sup> On the one hand, the organization focused on willingness of jurisdictions to cooperate to the exchange of tax information. On the other hand, there has been a general feeling that it has not properly addressed the most relevant issues of tax. Or has it?

The answer depends on the definition of tax havens itself and on the purpose of the list. Although there is no universally accepted definition of tax havens, taking a look at two different approaches by international governmental organizations gives a good start.

The Organization of American States (OAS) defines a tax haven as a territory or a state with a legal or tax system that protects capital ownership by granting anonymous, confidential and safe instruments of property.<sup>5</sup> Usually a small territory has adopted an attractive tax policy for foreign investments in order to compensate for the lack of natural resources.

This is a very general definition intended at describing a wide variety of practices. It focuses on territories lacking natural resources and that would otherwise not receive foreign investments, considered necessary for their development. The problem is twofold: territories not lacking natural resources that still engage in harmful tax practices and the line between a legitimate tax planning and an abusive one.

The OECD went a step further, setting the milestone in making tax haven lists two years after publishing its 1998 study named *Harmful Tax Competition: An Emerging Global Issue*.<sup>6</sup> The first

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<sup>3</sup> Vanessa Houlder, "Trinidad & Tobago left as the last blacklisted tax haven," *Financial Times*, 28 June 2017. Available from <https://www.ft.com/content/94d84054-5bf0-11e7-b553-e2df1b0c3220>.

<sup>4</sup> Alex Cobham, "Empty OECD 'tax haven' blacklist undermines progress," Tax Justice Network, 28 June 2017. Available from <https://www.taxjustice.net/2017/06/28/empty-oecd-tax-haven-blacklist-undermines-progress/>.

<sup>5</sup> Inter-American Drug Abuse Control Commission/Organization of American States. Available from <http://www.cicad.oas.org>.

<sup>6</sup> Available from [http://www.oecd-ilibrary.org/taxation/harmful-tax-competition\\_9789264162945-en](http://www.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en).

list, containing 35 tax havens, was challenged by most of the listed jurisdictions and was criticized for leaving out well-known international financial centers that offered low tax services, such as Singapore and Hong Kong.

Later on, the OECD launched the *Project on Harmful Tax Practices* and, after a few reports and updates, recognized that, besides tax havens, preferential tax regimes also represented a more subtle but harmful tax competition. The practical problem was that tax havens and preferential tax regimes were both relative concepts: countries with different levels of taxation might disagree on what exactly a low taxation is.

To overcome this practical difficulty, the OECD laid down four key factors to assess the harmfulness of a tax regime:

- (a) the regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities;
- (b) the regime is ring-fenced from the domestic economy;
- (c) the regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure); and
- (d) there is no effective exchange of information with respect to the regime.

Besides the four key factors, the OECD also considers eight other factors in determining whether a tax regime is potentially harmful:

- (a) an artificial definition of the tax base;
- (b) failure to adhere to international transfer pricing principles;
- (c) foreign source income exempt from residence country taxation;
- (d) negotiable tax rate or tax base;
- (e) existence of secrecy provisions;
- (f) access to a wide network of tax treaties;
- (g) the regime is promoted as a tax minimization vehicle; and
- (h) the regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.

Because of the project, the OECD developed an interesting model for analysing tax regimes but opened the door for negotiations to remove countries from the list as long as they agreed to sign Tax Information Exchange Agreements (TIEA) with OECD members. Thirty-three listed countries joined the negotiations and left the list, which eventually became empty.<sup>7</sup> That is, until the latest update in 2017.

As for the purposes of a list, according to Jason Sharman and Gregory Rawlings, authors of a STEP study,<sup>8</sup> there are four types of lists of tax havens:

- a) blacklists – lists of jurisdictions considered to be tax havens according to national or domestic law. Transactions to or from such jurisdictions are subject to higher levels of taxation or denial of fiscal benefits;
- b) informal blacklists – lists of jurisdictions considered to be potential tax havens according to national or domestic law, but with no automatic application of higher levels of taxation or denial of fiscal benefits;
- c) greylists – lists of jurisdictions that are not considered tax havens in general, but that still have some transactions subject to higher levels of taxation or denial of fiscal benefits in case certain conditions are observed; and
- d) whitelists – lists of jurisdictions that, according to national or domestic law, fulfil the criteria of having transactions from or to such jurisdictions receive a beneficial tax treatment, such as lower taxation or increased benefits.

According to these criteria, the OECD's is a blacklist, but is used to pressure for the signature of TIEAs with its members. The name of the list was changed to “non-cooperative jurisdictions” and the effects were extended from tax to commerce. So, considering the

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<sup>7</sup> List of uncooperative tax havens. Available from <http://www.oecd.org/countries/monaco/list-of-unco-operative-tax-havens.htm>.

<sup>8</sup> Jason Sharman and Gregory Rawlings, *Deconstructing National Tax Blacklists: Removing Obstacles to Cross-Border Trade in Financial Services* (London, Society of Trust and Estate Practitioners (STEP), 2005). Available from <https://www.step.org/sites/default/files/Comms/DeconstructingNationalBlacklists.pdf>.

definition, the type of list and the purpose of the OECD, the one-country list might have satisfied its requirements. The fact that this list will be of little use to developing countries might be a good one, if these countries take the opportunity to deepen the discussion on harmful tax practices, implementing definitions and tax policies adjusted to their own needs.

Section 2 presents the evolution of the definition and tax treatment of tax havens in Brazilian tax law between 1995 and 2015. Section 3 discusses the main results of this 20-year experience.

## **II. DESCRIPTION OF THE BRAZILIAN EXPERIENCE**

### ***II.1 Legal Roadmap***

Although the Brazilian tax law does not use the term “tax havens”, Article 24 of Law 9,430, dated 27 December 1996,<sup>9</sup> defines “countries with favoured taxation” as those where income tax rates of natural persons or entities are less than 20% (twenty per cent).

*Article 24. The provisions regarding prices, costs and interest rates, contained in arts. 18 to 22, also apply to transactions carried out by a natural or legal person residing or domiciled in Brazil, with any natural or juridical person, even if not related, resident or domiciled in a country that does not tax the income or that taxes it at a maximum rate lower than twenty percent.*

*Paragraph 1. For the purpose of the provisions in the final part of this article, the tax laws of that country, applicable to individuals or legal entities, shall be considered according to the nature of the entity with which the transaction was performed.*

*Paragraph 2. In the case of a natural person resident in Brazil:*

*I - the amount calculated according to the methods referred to in art. 18 will be considered as cost of acquisition for purposes of calculation of capital gain on the disposal of the good or right;*

*II - the price related to the good or right alienated, for purposes*

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<sup>9</sup> Brazil, Law 9,430, dated 27 December 1996. Available from [http://www.planalto.gov.br/ccivil\\_03/leis/L9430.htm](http://www.planalto.gov.br/ccivil_03/leis/L9430.htm).

*of calculation of capital gain, will be verified in accordance with the provisions of art. 19;*

*III - the price of services rendered, determined in accordance with the provisions of art. 19, will be considered as taxable income;*

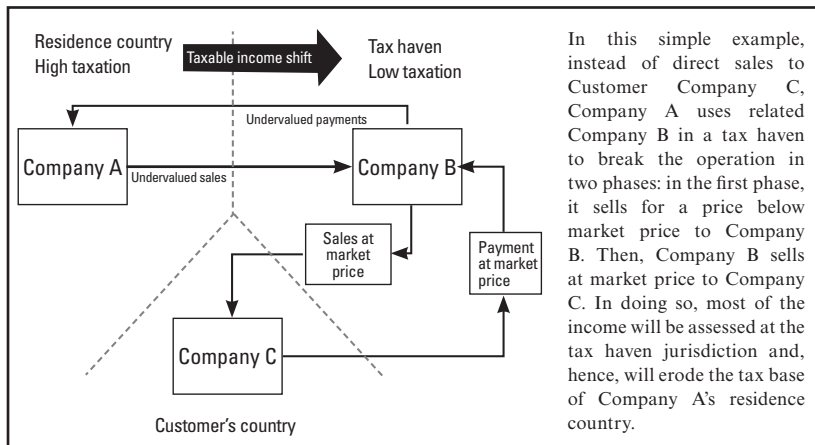
*IV - the interest determined in accordance with art. 22 will be considered as taxable income.*

*Paragraph 3. For the purposes of the provisions of this article, the taxation of labour and the taxation of capital, as well as the dependencies of the country of residence or domicile, will be considered separately. (Redaction given by Law 10,451/2002)*

*Paragraph 4. A country or dependency whose legislation does not allow access to information on the corporate composition of legal entities, their ownership or the identification of the beneficial owner of income attributed to non-residents are also considered to have a favoured taxation. (Included by Law 11,727/2008) (underlined)*

The law aimed at applying transfer pricing rules to such cases, regardless of the transactions being performed between related parties or not. A favoured taxation could distort prices, shifting profit away from the national tax base, as shown in the example in Box 1.

### Box 1 – How favoured taxation distort prices



Transfer pricing rules would ensure that a fair amount of profit remained subject to tax in Brazil. According to the Explanatory Memorandum of Law 9,430/1996,

*“5. Articles 18 to 24 lay down rules for companies that maintain import operations from or export operations to related foreign companies abroad, as well as for companies, related or not, located at countries known as “tax havens”, concerning the calculations of the results of such operations to be included in the tax base of corporate income tax.*

*The law lays down procedures to compare prices registered in import or export documentation to average prices of identical operations between unrelated parties, in order to determine the values to be added as import expenses or export revenues in the computation of taxable income.*

*The above mentioned comparison between average prices (or average expenses) and prices registered in import or export documentation may be carried out by the company itself and, based on such comparison, the company will eventually make the necessary adjustments in the Actual Profits Determination Book. In the omission of the company, the tax inspection will perform such comparison and, by the means provided for in this law, may require that the company pay the eventual difference between tax due and tax paid.”*

The rule was self-applicable and did not require any official list. Even the procedure of withholding taxes had been in place for more than 50 years. Indeed, according to articles 99 to 103 of Decree 5,844, dated 23 September 1943,<sup>10</sup> banks and other financial institutions were responsible for withholding the due tax from applicable transactions and for transferring that due amount to the National Treasury in 30 days, even if they had not actually withheld the due tax from their clients' transactions.

## *CHAPTER II – ON TAX WITHHOLDING*

*Article 99. The source is responsible for withholding the tax referred to in Articles 95 and 96 at the moment of the credit or payment of the income.*

<sup>10</sup> Brazil, Decree-Law 5,844, dated 23 September 1943. Available from [http://www.planalto.gov.br/ccivil\\_03/decreto-lei/Del5844.htm](http://www.planalto.gov.br/ccivil_03/decreto-lei/Del5844.htm).

*Art. 100. The source is responsible for withholding the tax referred to in Articles 97 and 98, when it pays, credits, employs, remits or delivers the income. (See Law 9,249/1995)*

*Sole paragraph. The provisions of the header of this Article do not apply to the following cases, when it is up to the proxy to withhold the due tax:*

- a) when the income derives from the rental of immovable property;*
- b) when the proxy fails to inform the source that the beneficiary of the income is resident or domiciled abroad.*

### *CHAPTER III – ON TAX COLLECTION*

*Article 101. The persons responsible for withholding the tax are also responsible for collecting it to the tax offices.*

*Article 102. The tax collection shall be realized within 30 days from the due date of the withholding tax by the source or by the proxy of the resident or domiciled abroad.<sup>12</sup>*

*Sole paragraph. In the case of real estate rents, the collection of the tax will be made every six months, during the months of January and July of each year, and will include the sum of the amounts withheld in the immediately previous semester. (Included by Law 154/1947)*

*Article 103. In case the due withholding tax has not been retained, the source or the proxy will be responsible for transferring the value of the due tax, as if it had been retained.*

Although self-applicable, the rule still required a case-by-case analysis to identify whether a jurisdiction had a favoured taxation or not. The financial sector considered that the cost of such an analysis should be supported by the Government and, for legal certainty, that its results should be made publicly available.

The private sector claims resulted in Normative Instruction (NI) SRF 33, dated 30 March 2001,<sup>11</sup> which published the first list of jurisdictions with favoured taxation. In the following year, NI SRF

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<sup>11</sup> Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?idAto=13557&visao=anotado>.



188, dated 6 August 2002,<sup>12</sup> added nine other jurisdictions to the list. For the complete evolution of listed jurisdictions in the Brazilian list from 2001 to 2016, please refer to the table in Box 2.

**Box 2 – Evolution of the Brazilian list of tax havens – Listed Jurisdictions**

In the table below, the terms have the following meaning:

**x** = the jurisdiction remains listed in that year

**included** = the jurisdiction was listed in that year

**renamed** = the jurisdiction was listed under a new name (or names)

**regime** = the jurisdiction was excluded from the list, but had a regime included in the list of preferential tax regimes

Total number of listed jurisdictions:	44	54	65	66	68
Jurisdictions	2001	2002	2010	2014	2016
American Samoa	included	x	x	x	x
American Virgin Islands	included	x	x	x	x
Andorra	included	x	x	x	x
Anguilla	included	x	x	x	x
Antigua and Barbuda	included	x	x	x	x
Aruba		included	x	x	x
Ascension Island			included	x	x
Bahamas, The	included	x	x	x	x
Bahrain	included	x	x	x	x
Barbados	included	x	x	x	x
Belize	included	x	x	x	x
Bermuda	included	x	x	x	x
British Virgin Islands	included	x	x	x	x
Brunei			included	x	x
Campione D'Italia		included	x	x	x
Cayman Islands	included	x	x	x	x
Channel Islands, The	included	x	x	x	x
Cook Islands	included	x	x	x	x
Costa Rica	included	x	x	x	x
Curacao	included	x	x	x	x
Cyprus	included	x	x	x	x
Djibouti	included	x	x	x	x
Dominica	included	x	x	x	x
French Polynesia			included	x	x

<sup>12</sup> Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado&idAto=15054>.

Gibraltar	included	x	x	x	x
Grenada	included	x	x	x	x
Hong Kong		included	x	x	x
Ireland					included
Isle of Man	included	x	x	x	x
Kiribati			included	x	x
Labuan	included	x	x	x	x
Lebanon		included	x	x	x
Liberia	included	x	x	x	x
Liechtenstein	included	x	x	x	x
Luxembourg		included	regime	x	x
Macau		included	x	x	x
Madeira Island	included	x	x	x	x
Maldives		included	x	x	x
Malta	included	x	regime	x	x
Marshall Islands	included	x	x	x	x
Mauritius	included	x	x	x	x
Monaco	included	x	x	x	x
Montserrat Island	included	x	x	x	x
Nauru	included	x	x	x	x
Niue Island	included	x	x	x	x
Norfolk Island			included	x	x
Oman		included	x	x	x
Panama	included	x	x	x	x
Pitcairn Islands			included	x	x
Qeshm Island			included	x	x
Saint Helena			included	x	x
Saint Kitts and Nevis	included	x	x	x	x
Saint Lucia	included	x	x	x	x
Saint Pierre and Miquelon			included	x	x
Saint Vincent and the Grenadines	included	x	x	x	x
Samoa	included	x	x	x	x
San Marino	included	x	x	x	x
Seychelles	included	x	x	x	x
Singapore			included	x	x
Sint Maarten	included	x	x	x	x
Solomon Islands			included	x	x
Swaziland			included	x	x
Switzerland			included	regime	x
Tonga	included	x	x	x	x
Tristan da Cunha			included	x	x
Turks and Caicos Islands	included	x	x	x	x
United Arab Emirates		included	x	x	x
Vanuatu	included	x	x	x	x

Although it was long, the list failed to include some cases of tax planning that resulted in taxation much lower than the Brazilian standards. One example was the American state of Delaware, where certain legal structures allowed for tax-haven-like benefits (low taxation and secrecy). The same happened to the state of Nevada, especially in the casino sector. In both states, companies could elude federal taxation in the United States. However, the two states were not dependencies, nor countries on their own.

Realizing the lack of legal basis to include just part of a country in its list, Brazil enacted Law 11,727, dated 23 June 2008,<sup>13</sup> which, as stated in its article 23, included articles 24-A and 24-B in Law 9,430/1996 to define preferential tax regimes and provide for the possibility of administratively adjusting tax rate thresholds.

*Article 23. Law 9,430, dated 27 December 1996, is hence amended to include the following Articles 24-A and 24-B:*

*“Article 24-A. The provisions regarding prices, costs and interest rates, set forth in articles 18 to 22 of this Law shall also be applied in transactions carried out under a privileged tax regime between individuals or legal entities resident or domiciled in Brazil and individuals or legal entities resident or domiciled abroad, even if they are not related.*

*Sole paragraph. For the purposes of this article, it is considered preferential the tax regime that presents one or more of the following characteristics:*

*I – it does not tax income or taxes it at a maximum rate lower than 20% (twenty per cent);*

*II – it grants a tax benefit to a non-resident individual or legal entity:*

*a) with no requirement of realization of substantial economic activity in the country or dependency;*

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<sup>13</sup> Available from [http://www.planalto.gov.br/ccivil\\_03/\\_ato2007-2010/2008/lei/111727.htm](http://www.planalto.gov.br/ccivil_03/_ato2007-2010/2008/lei/111727.htm).

*b) conditioned to the absence of substantial economic activity in the country or dependency;*

*III – it does not tax, or taxes at a maximum rate lower than 20% (twenty per cent) any inbound income;*

*IV – it does not grant access to information related to societary composition, ownership of assets or rights or to economic operations performed.”*

*“Article 24-B. The Executive Branch may reduce or re-establish the percentage values set forth in the header of Article 24 and in the indents I and III of the sole paragraph of Article 24-A, both of this Law.*

*Sole paragraph. The option provided for in the header of this Article may also be applied, in an exceptional and restrict way, to countries that form economic blocs of whom Brazil is a member.”*

Hence, according to the legal definition, a tax regime is deemed preferential if it has one or more of the following characteristics:

- (a) No income tax or income tax lower than 20% (twenty per cent);
- (b) Fiscal benefits to non-resident natural or legal persons with no substantial economic activity in the territory;
- (c) No income tax or income tax lower than 20% (twenty per cent) on inbound income; or
- (d) Does not grant access to information on legal ownership of companies, assets or rights or to the economic operations performed.

The definition of preferential tax regimes, reflecting the sophistication of worldwide tax practices, enabled the tax administration to better deal with harmful regimes inside jurisdictions that did not have a general favoured taxation. In particular, the second characteristic, lack of economic substance, was justified because most entities that were created only to avoid tax do not have economic substance, that is, they may be just post-office companies.

As a federal prosecutor once stated,<sup>14</sup> “Brazil is so aware of the (in)correct (ab)use of tax havens that the Council for the Control of Financial Activities (COAF – Conselho de Controle de Atividades Financeiras), in one of its first booklets on money laundering, declared that both tax havens and offshore centers share a legitimate purpose and a certain commercial justification. However, the main cases of money laundering discovered in recent years involved criminal organizations that abused the facilities offered by them to accomplish illegal manoeuvres”.

When the law that defined preferential tax regimes came into force, the private sector once again claimed that it was up to the Government to state which tax regimes were preferential and, hence, subject to the specific tax treatment described in the next subsection.

Normative Instruction (NI) RFB 1,037, dated 4 June 2010,<sup>15</sup> consolidated in a single list both types of tax havens defined in Law 9,430/1996: jurisdictions with favoured taxation (Article 24) and preferential tax regimes (Article 24-A).

Soon after the publication of the new, comprehensive list, NI RFB 1,045, dated 23 June 2010,<sup>16</sup> allowed for requirements for review of the list. Listed countries could then present relevant modifications in their tax law that enabled the review and, eventually, the exclusion from the list.

At that moment, there had already been an evolution in the international understanding that transparency could be an effective tool

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<sup>14</sup> Diego Pereira Machado, *Países com tributação favorecida (tax havens ou paraísos fiscais): ainda em uso!* 23 December 2016. Available from <http://esdp.net.br/paises-com-tributacao-favorecida-tax-havens-ou-paraissos-fiscais-ainda-em-uso/>.

<sup>15</sup> Normative Instruction RFB 1,037, dated 4 June 2010. Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado&idAto=16002>.

<sup>16</sup> Normative Instruction RFB 1,045, dated 23 June 2010. Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado&idAto=16010>.

to tackle the problems related to the abuse of tax havens. The OECD, for example, changed its focus from the low or no taxation criteria to the fiscal transparency and exchange of information ones. Recognizing such evolution, Brazil implemented the possibility of reducing the tax haven threshold of income tax rate from 20% to 17%, in case the other jurisdiction complied with some international standards of transparency.

According to NI RFB 1,530, dated 19 December 2014,<sup>17</sup> countries are deemed to comply with “international standards of fiscal transparency” if they have signed a convention or an agreement providing for exchange of information on tax matters with Brazil and if they have committed to take measures against tax evasion according to criteria set by international fora in which Brazil takes part, such as the Global Forum on Transparency and Exchange of Information for Tax Purposes. These are cumulative conditions, so the country should meet both conditions to be considered compliant with international standards of fiscal transparency.

NI RFB 1,530/2014 also establishes the procedure for listed jurisdictions to require review of the list, which basically involves an official requirement with proof of the entry into force of legislative changes that comply with both taxation and transparency criteria. NI RFB 1,560, dated 20 April 2015,<sup>18</sup> which made some language improvements to NI RFB 1,530/2014, has updated this procedure.

NI RFB 1,658, dated 16 September 2016,<sup>19</sup> implemented the latest reviews, updating the list of NI RFB 1,037/2010. It also stated the concept of “substantial economic activity” for the purpose of analysing preferential tax regimes. According to this provision, economic substance requires appropriate operational capacity, which

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<sup>17</sup> Normative Instruction RFB 1,530, dated 19 December 2014. Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado&idAto=59597>.

<sup>18</sup> Normative Instruction RFB 1,560, dated 20 April 2015. Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado&idAto=63354>.

<sup>19</sup> Normative Instruction RFB 1,658, dated 13 September 2016. Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado&idAto=77307>.

is evidenced by qualified staff and physical installations suitable (in quality and in quantity) for the management and effective decision making related to the activities aimed at generating income from own assets or from the participation in other companies, via dividends or capital gains. Finally, NI RFB 1,683, dated 29 December 2016,<sup>20</sup> made language improvements to NI RFB 1,037/2010.

## **II.2 Tax Treatment**

As explained in the previous section, a single law (Law 9,430/1996) defines “jurisdictions with favoured taxation” and “preferential tax regimes” and the Brazilian list of tax havens (NI RFB 1,037/2010) includes both types. The tax effects of being a tax haven, however, are found in a variety of legal acts. The main effects (and their legal bases) are:

- (a) automatic application of transfer pricing rules (Law 9,430/1996, articles 18 to 22);
- (b) automatic application of withholding tax rate at 25% (Law 9,779/1999, article 8);
- (c) automatic application of thin capitalization rules and reduction of the debt-equity ratio from 200% to 30% of net worth value (Law 12,249/2010, articles 25 and 26);
- (d) additional restrictions to deduct expenses related to payments made to the jurisdiction from the tax base of the corporate income tax due in Brazil (only necessary and ordinary expenses for the maintenance of the source of income are deductible); and
- (e) application of controlled foreign company rules, which include the taxation of profits earned by the holding companies located in the jurisdiction on 31 December of each taxable period, regardless of its characterization as an affiliated company and of the deferred payment system; and prohibition of the use of the deemed tax credit of 9% (Law 12,973/2014, articles 78, 81, 83 and 91).

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<sup>20</sup> Normative Instruction RFB 1,683, dated 29 December 2016. Available from <http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado&idAto=79465>.

The effects of being a tax haven have also evolved during the two decades under consideration. The initial proposal of applying transfer-pricing rules aimed at avoiding price distortion in transactions between related companies, usually belonging to the same multinational group. This effect still applies today, but new treatments have been included to consider other aspects of a harmful tax competition.

For instance, applying withholding taxes at a higher rate does preserve tax collection, as tax payment and collection do not depend on the operations conducted abroad. For example, the normal withholding tax rate of 15% is increased to 25% in case the payee is located in a tax haven. In other words, it saves the same tax in advance.

Thin capitalization rules, on the other hand, deal with a different problem, that of choosing an unrealistic proportion between equity and debt financing in order to have a lower overall taxation. Paying interests on loans may not only shift profit to the payee jurisdiction, but is also usually deductible from the tax base of the payer, leaving a smaller taxable income in its country. Here, the normal allowance for a 200% debt/equity ratio is reduced to 30% in case the payee is located in a tax haven.

Limiting the deductibility of expenses to those that are necessary and ordinary to the company's main activity, its source of income, is another way to prevent abuse of national tax law and international tax treaties. For instance, it is common for local subsidiaries to make contractual payments to their overseas parent company for technical assistance. The contents of the contract may vary greatly, but sometimes they include activities that benefit only the parent company. For example, the subsidiary might be paying for expenses related to board meetings of the parent company, which is not essential for the subsidiary's main activity. In that case, the deductibility of such payment from the subsidiary's income will not be allowed.

### **III. ANALYSIS OF THE POLICY'S IMPACT**

Two decades have elapsed since the enactment of Law 9,430/1996 and there have been changes in both the theory and the practice of tax havens. The publication of the latest OECD's blacklist in July 2017 and the criticisms it has received make it a good timing to step back and also take a critical look



at the evolution of the Brazilian list of tax havens, its accomplishments and problems it did not solve.

There are many ways to analyse the impact of a tax policy. In this chapter, we take a look at a single statistic often cited to criticize any change in government policy: foreign direct investment (FDI). No matter what policy, which sector is in discussion, there will always be claims that a change will ruin investments in that sector, especially, the ones from abroad.

So, we will check the impact of the changes in Brazilian tax law related to tax havens on FDI, during the 20 years from the enactment of Law 9,430/1996 until the latest NI RFB 1,683/2016.

### ***III.1 Foreign Direct Investment (FDI)***

In the present analysis, we classify FDI into three categories, according to its origin: FDI from listed jurisdictions, FDI from jurisdictions with a valid agreement to avoid double taxation (DTA – double taxation agreement) with Brazil, and FDI from other jurisdictions (not listed, no DTA with Brazil). The sum of FDI from all three categories will be referred to as Total FDI. We shall look at divergences between the evolution of Total FDI and that of each category. The data on the amount of FDI is publicly available at the Central Bank of Brazil’s website. Table 1 shows the evolution of FDI between 1995 and 2015.

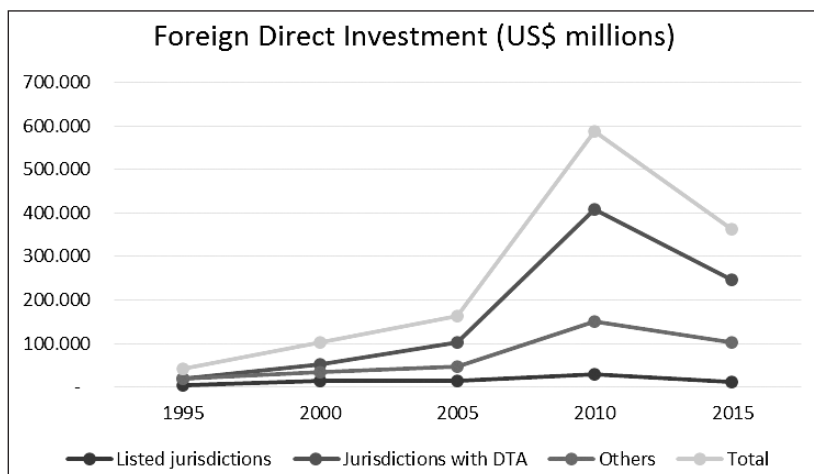
Table 1 - Evolution of Foreign Direct Investment (1995-2015)

Foreign Direct Investment - FDI (US\$ mi)	1995	2000	2005	2010	2015
Listed jurisdictions	4.219	14.683	14.158	28.843	12.606
Jurisdictions with DTA	18.135	52.902	102.908	408.295	246.864
Others	19.342	35.429	45.742	150.071	103.046
<b>Total</b>	<b>41.696</b>	<b>103.015</b>	<b>162.807</b>	<b>587.209</b>	<b>362.516</b>
FDI / Total FDI (%)	1995	2000	2005	2010	2015
Listed jurisdictions	10%	14%	9%	5%	3%
Jurisdictions with DTA	43%	51%	63%	70%	68%
Others	46%	34%	28%	26%	28%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

*Data source: Central Bank of Brazil*

When the Brazilian Government published its first tax havens list, it was a blacklist aimed at avoiding the erosion of its tax base. A massive outflow of FDI would certainly be one way that such erosion occurs. However, as a general observation, Total FDI had increased 9 times from 1995 to 2015, with a peak in 2010. All categories seemed to have followed a similar pattern in the period, as shown in Graph 1, which represents the values on Table 1 in a visual manner.

**Graph 1 – Evolution of FDI in Brazil (1995-2015)**



The absence of massive FDI outflows in the period is evidence that the tax policy, in general, did not have a net negative impact on investments. Focusing on the FDI from listed jurisdictions reveals some specific impacts of the policy.

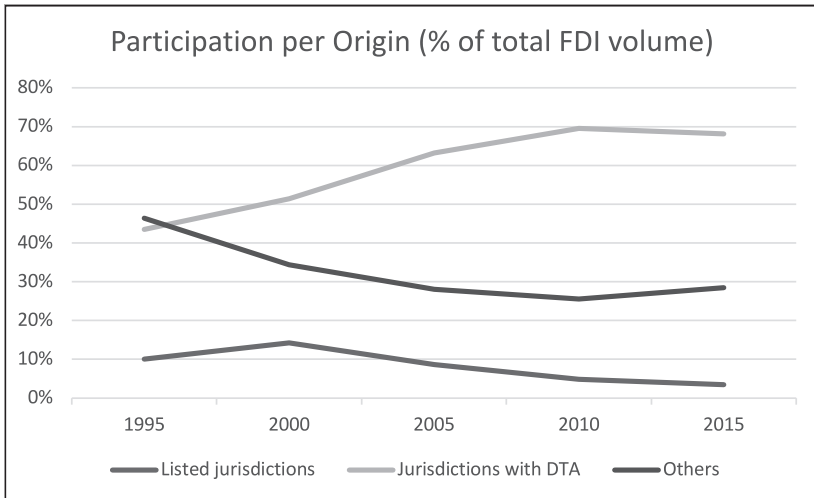
The first list of tax havens, published in 2001, seems to have stopped new investments from listed jurisdictions until 2005, while total FDI kept increasing. In fact, while the absolute amount of FDI from listed jurisdictions remained at the US\$ 14 billion level, its relative participation in total FDI declined from 14% to 9%. That is,

the list made a change in the composition of FDI, shifting the flow from tax havens to other jurisdictions, especially those with a DTA.

From 2005 to 2010, the amount of FDI from listed jurisdictions doubled from the US\$ 14 billion level to the US\$ 28 billion level. However, in relative terms, its participation in total FDI decreased from 9% to 5%. Once again, there was a shift of investment flow from tax havens to other jurisdictions, especially those with a DTA.

Finally, from 2010 to 2015, the amount of FDI from listed jurisdictions decreased from the US\$ 28 billion level to the US\$ 12 billion level. Total FDI and other FDI categories also decreased in the period, but none showed a decrease as steep as FDI from listed jurisdictions. In terms of participation, listed jurisdictions accounted for 3% of Total FDI. There was also a shift of investment flow from tax havens to other jurisdictions. This time, however, jurisdictions with no DTA seemed to have a higher increase. Further investigation would be needed to verify if this indicates the emergence and use of new tax regimes in countries with no DTA and which are not listed yet. Graph 2 shows the participation of FDI per origin between 1995 and 2015.

**Graph 2 – FDI Participation (per origin) in Brazil (1995-2015)**



Here it is clear that investment flow has constantly shifted from tax havens to other jurisdictions. In this sense, the combined application of increased withholding tax, transfer pricing rules, limitation of benefits (deductibility of expenses from the tax base), thin capitalization rules etc. proved effective in reducing the participation of FDI from listed jurisdictions in Total FDI from 14% in 2000 to 3% in 2015. That reduction represents an efficiency rate of 78%.

This efficiency rate might have been somewhat higher, had the effects of a preferential tax regime been the same as those of a jurisdiction with favoured taxation. The definition of preferential tax regime corresponds to a global trend to prevent and counter harmful tax practices. As implemented by Law 11,727/2008, the practical effect is the application of transfer pricing rules to compensate for the distortion in transactions between related parties or with residents of tax havens. The automatic application of an increased withholding tax was left out.

Obviously, there might be other factors that account for this efficiency rate, such as the celebration of DTAs with new jurisdictions, measures aimed at promoting the country as a destination for FDI and improvements in national infrastructure. All these initiatives could increase the volume of FDI from jurisdictions other than listed ones and, thus, reduce the participation of listed jurisdictions in total FDI. But it seems reasonable to affirm that the definition and the tax treatment of tax havens in the Brazilian legislation have had the double effect of reducing FDI from listed jurisdictions and strengthening FDI from non-listed jurisdictions, which is expected to broaden the country's tax base as well.

#### **IV. LESSONS LEARNED**

(a) Having a tax havens list proved useful to shift foreign direct investment from tax havens to other jurisdictions, especially those with a double taxation agreement. Tax incentives should not be the only reason for structuring a business in a country and fighting harmful tax practices should not be the only reason for refraining from structuring a business in a country. Real economic reasons, such as natural and

human resources, location and infrastructure and maturity of the economic market should be taken into consideration when elaborating a business plan and when designing a tax policy. Accordingly, common arguments about losing FDI if a certain measure is implemented should be carefully verified. In the Brazilian experience, instead of a decrease in total FDI, there has rather been a shift in their origin, with preferable consequences to the national tax base.

(b) Including both penalties and rewards seems to account for a more efficient implementation of a tax policy. Punishing unwanted behaviour is one way of enforcing economic policies, but it is not the only one. Rewarding good behaviour is another one. In tax matters, applying increased taxation, limiting benefits or requiring extra obligations are examples of penalties for unwanted behaviours. Signing a double taxation agreement, granting economic benefits, requiring simplified obligations are examples of rewards for wanted behaviours. Combining penalties and rewards might increase the efficiency of tax policies, such as observed in the combination of a more rigorous tax treatment for tax havens with a policy of signing agreements with other jurisdictions to avoid double taxation.

(c) The mere existence of a list, however, does not solve all problems related to tax havens. A tax havens list should be considered as part of a broader tax policy tailored to national interests.

Despite of the positive impacts of having a list of tax havens highlighted in this chapter, there are also negative implications that should be considered, such as maintenance and political costs of the list. There should be a qualified and sufficient team to update the list and to provide technical arguments in political negotiations. It should also be noted that every development policy starts with a coherent tax reform and that there is no one-size-fits-all solution because the starting conditions, interests and difficulties are different for each nation.

(d) Exhaustive lists do not always reflect the spirit of the law, and as such, the requirement of listing jurisdictions should be balanced against other principles, particularly considering the specific interests and needs of each State.



# CHAPTER 9

## ECUADOR AND ITS FIGHT AGAINST TAX HAVENS<sup>1</sup>

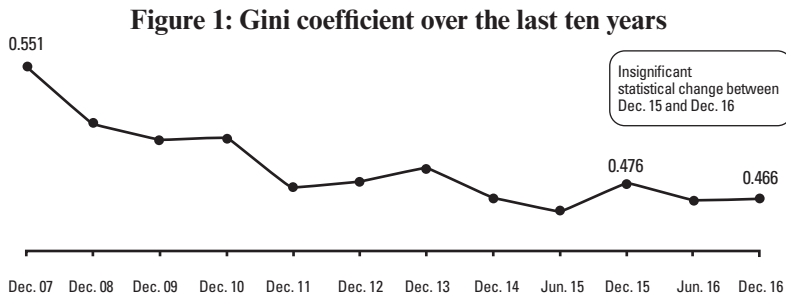
Lorena Freire Guerrero

*“In a globalized world, if there is any pocket of secrecy, funds will flow through that pocket. That is why the system of transparency has to be global.”*

- Joseph Stiglitz, 2001 Nobel Prize in Economic Sciences

### I. MACRO SITUATION IN ECUADOR

Ecuador has a population of 16 million, with a gross domestic product (GDP) in 2016 of around US\$ 100 billion. As in Latin America as a whole, wealth is poorly redistributed in the country, although significant improvements have been made in recent years: in 2007 the country had a Gini coefficient of 0.551, and ten years later the figure had dropped to 0.466. This indicates a clear improvement in equality, although there is still a real need to keep working towards equality. The graph below shows the change in the Gini coefficient over the last ten years.



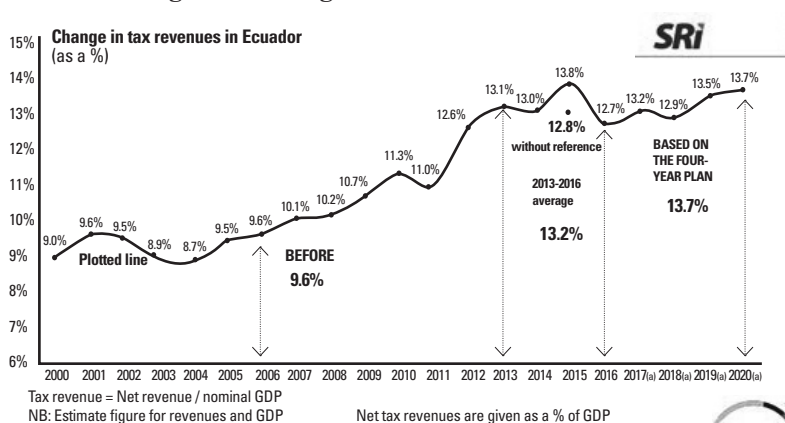
NB: Statistical significance is based on a confidence level of 95%  
Gini score.

Source: INEC ([http://www.ecuadorencifras.gob.ec/documentos/web-inec/POBREZA/2016/Diciembre\\_2016/122016\\_Presentacion\\_Pobreza.pdf](http://www.ecuadorencifras.gob.ec/documentos/web-inec/POBREZA/2016/Diciembre_2016/122016_Presentacion_Pobreza.pdf))

<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 1 (May 2018).

Taxation has been a key tool in improving the country's coefficient. Ecuador has improved how it manages tax collection and implemented domestic anti-fraud regulations and international mechanisms concerning aspects such as transfer pricing and tax havens. These measures have helped to increase the tax base, which has had a positive impact on the redistribution of wealth and equality. The increase in the tax base has also led to more social investments in health care, education, the road infrastructure, etc.

**Figure 2: Change in tax revenues in Ecuador**



Source: *Servicio de Rentas Internas del Ecuador*

## II. THE MONETARY SYSTEM IN ECUADOR AND THE IMPORTANCE OF THE MONEY SUPPLY FOR THE COUNTRY'S ECONOMY

The money supply is essential to the economy of any country. However, it is all the more so for Ecuador because the country does not have its own currency and has used the U.S. dollar as its currency since 2000. This means that it cannot use foreign exchange policies to make its currency more competitive and to help generate exports and restrict imports.

Dollarization relies heavily on the country's capacity to attract capital and prevent it from leaving the economy. However, this requires great effort, given the unfair competition from tax havens. Their attractiveness causes capital flight, which decreases domestic wealth, restricts domestic



investment and reduces the money supply in the economy, which is the foundation of a dollarized system. This renders the economy of Ecuador and its financial system more fragile. Without monetary sovereignty,<sup>2</sup> the economy is more vulnerable to international capital markets and the “advantages” offered by tax havens.

### III. TAX HAVENS IN FIGURES

Tax havens are harmful to global transparency; they also draw capital away from and damage countries that produce real wealth. They represent unfair competition because their attractiveness is based on secrecy and opacity, making them accomplices to actions such as tax evasion, corruption and money laundering.

Tax havens essentially represent an ethical and moral issue that has repercussions on the economies of other nations. Indeed, the money hidden in tax havens would be enough for 32 million people to be lifted out of poverty.<sup>3</sup> According to the United Nations Economic Commission for Latin America and the Caribbean (UN ECLAC), around US\$ 320 billion in taxes are lost to tax havens on the income of individuals and companies in Latin America.<sup>4</sup>

There are many estimates of the impact of tax havens, but they are just that: estimates. It is difficult to access more accurate data. And some data that have been accessed have been obtained through leaks such as Swiss Leaks<sup>5</sup> and the Panama Papers.<sup>6</sup> Below are some more figures:

- It is estimated that 8% of the world’s financial wealth – or US\$ 7.6 trillion – is located in tax havens. It is also estimated that around

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<sup>2</sup> The capacity of a State to issue its own currency, control aspects of its exchange rate with other currencies, the exchange-rate regime and interest rates for its currency, as well as other money-related aspects within the territory in which it exercises national sovereignty. (Caixa)

<sup>3</sup> Winnie Byanyima, “Fighting inequality in Latin America: The road ahead,” 8 December 2014. Available from <https://blogs.oxfam.org/es/node/24205>.

<sup>4</sup> Susana Ruiz Rodríguez, Rosa Cañete Alonso, Michael Hanni, Ricardo Martner, Daniel Titelman, *Time to tax for inclusive growth* (Santiago, UNECLAC, Oxfam, March 2016). Available from <https://www.cepal.org/en/publications/39950-time-tax-inclusive-growth>.

<sup>5</sup> Swiss Leaks is the name of a journalistic investigation into a tax evasion scheme allegedly operated with the knowledge and encouragement of the British multinational bank HSBC via its Swiss subsidiary.

<sup>6</sup> Panama Papers is the name given to the major leak of financial information managed by tax havens with help from the fourth largest law firm in the world, Mossack Fonseca.

US\$ 700 billion belonging to people in Latin America is located in tax havens, representing 22% of the region's total financial wealth, and that most of this amount (on average around 80%) has not been declared to the relevant tax authorities.<sup>7</sup>

- Offshore companies hold 22% of the world's wealth, which prevents States from investing in health care and education.<sup>8</sup>
- The World Bank estimates that more than €8 trillion are located in tax havens, which the International Monetary Fund (IMF) says represents a quarter of global private wealth.<sup>9</sup>
- Based on Organisation for Economic Co-operation and Development (OECD) data, some sources have estimated that the value of the wealth of high-net-worth individuals in offshore territories is US\$ 5.7 trillion, while Oxfam estimated in May 2013 that the figure amounted to US\$ 18.5 trillion.<sup>10</sup>
- The OECD's Secretary-General, Angel Gurría, said in 2008 that developing countries are estimated to lose to tax havens almost three times what they get from developed countries in aid.<sup>11</sup>
- In a July 2012 study, the non-profit organization Tax Justice Network estimated that the offshore sector was worth between US\$ 21 and 32 trillion.<sup>12</sup>

<sup>7</sup> ECLAC, *Economic Survey of Latin America and the Caribbean, The 2030 Agenda for Sustainable Development and the challenges of financing for development* (Santiago, 2016).

<sup>8</sup> "Registro Oficial Publica Ley Contra Paraísos Fiscales En Ecuador," 8 September 2017. Available from <https://www.confirmado.net/registro-oficial-publica-ley-paraisos-fiscales-ecuador>.

<sup>9</sup> Fundacion Melior, « Paraísos fiscales o el fraude a escala planetaria ». 8 February 2012. Available from <http://www.fundacionmelior.org/content/tema/para%C3%ADsos-fiscales-o-el-fraude-a-escala-planetaria>.

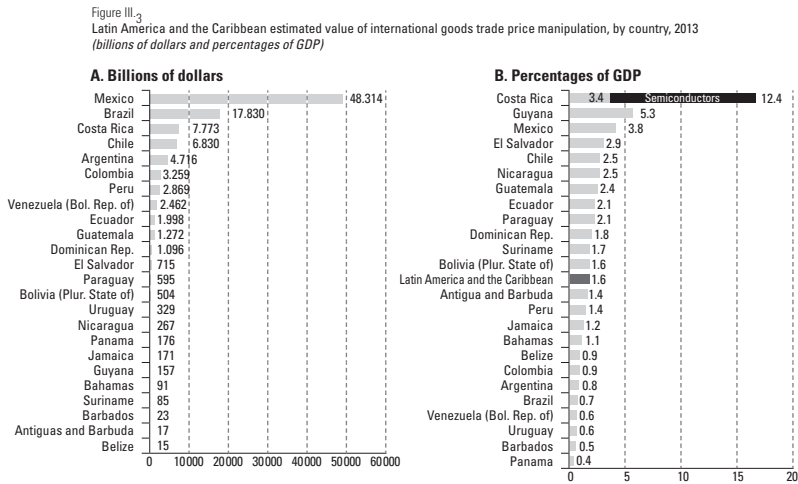
<sup>10</sup> Oxfam International, "Tax on the "private" billions now stashed away in havens enough to end extreme world poverty twice over", 22 May 2013. Available from <https://www.oxfam.org/en/press-releases/tax-private-billions-now-stashed-away-havens-enough-end-extreme-world-poverty-twice>.

<sup>11</sup> Angel Gurría, "The Global Dodgers", *The Guardian*, 27 November 2008. Available from <https://www.theguardian.com/commentisfree/2008/nov/27/comment-aid-development-tax-havens>.

<sup>12</sup> James S. Henry, "The Price of Offshore Revisited - New estimates for "missing" global private wealth, income, inequality, and lost taxes" (Tax Justice Network, July 2012). Available from [https://www.taxjustice.net/wp-content/uploads/2014/04/Price\\_of\\_Offshore\\_Revisited\\_120722.pdf](https://www.taxjustice.net/wp-content/uploads/2014/04/Price_of_Offshore_Revisited_120722.pdf).

Large multinationals use a series of mechanisms to reduce their tax bill. According to Zucman, they misuse bilateral treaties to generate undeclared income (what is known as treaty shopping), manipulate transfer prices and shift profits. In this context, stress has been laid on the importance of practices involving the transfer of profits or costs between subsidiaries of a single multinational company, from countries or States with high tax levels or administrative constraints on capital flows to jurisdictions with systems applying relatively low or zero taxation (tax havens), via the manipulation of transfer prices.<sup>13</sup>

**Figure 3: Transfer pricing and GDP**



Source: Economic Commission for Latin America and the Caribbean (ECLAC)

These figures are alarming and call for a reflection on the actions to be taken to address tax havens and the “advantages” they offer – such things cannot be considered an advantage if they come at a cost, above all, to the most vulnerable members of society because

<sup>13</sup> ECLAC, Economic Survey of Latin America and the Caribbean, The 2030 Agenda for Sustainable Development and the challenges of financing for development (Santiago, 2016).

States' resources become limited, which reduces investment in health care, housing, education and other public development policies. In Ecuador, despite recent efforts, social investment is still below the average for Latin America and the Caribbean; spending on education and health care per capita represent just 57.5% and 26.5% of the average for Latin America and the Caribbean, respectively.<sup>14</sup>

We cannot wait any longer to take decisions, especially since international and domestic initiatives to eliminate such behaviour are perceived to have been ineffective. Yet every action should be considered in the same way as those described by José Luis Prieto in *Estrellas de mar*, in which the apparently insignificant actions of a child saved so many starfish. Although many thought that the efforts of the child were insignificant, it was worth it for every starfish he saved. This is the same for every action taken by every country: they may seem insignificant to many people, but the funds that they manage to recover are worth it for each person who gains access to health care and education and increases their standard of living. In other words, even the smaller action can contribute to someone's wellbeing.

Countries are responsible for fighting these evasive and elusive practices in an integral and coordinated manner. As part of these efforts, the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) has taken on a greater role as the multilateral body leading international actions in the area of transparency and the exchange of tax information. However, every joint or individual effort will be effective only if there is a real desire to eliminate these harmful practices. This could be achieved through a public register of financial information that is available to all tax authorities worldwide.

This fight is not easy, as there are many factors that have encouraged and facilitated evasive and elusive practices, as indicated by Diaz Corral in the fourth edition of the training “Nociones

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<sup>14</sup> ECLAC, Social Panorama of Latin America (Santiago, 2012).

de Fiscalidad Internacional”, which highlights factors that have contributed to the increase in this type of practices over the last 20 years. These include:

- the increased mobility of people and capital;
- financial innovation;
- the internet;
- the existence and use of offshore financial centres to hide assets and income;
- tougher competition, which puts pressure on companies to reduce their effective tax rate;
- the existence of aggressive tax planning strategies;
- the globalization of the economy;
- the lack of fiscal awareness in the global population;
- the lack of coordination between national legislation and tax competencies between States.

These factors are difficult to address, especially since in States like Ecuador, tax evasion and avoidance are unfortunately not yet considered socially unacceptable. The population is indifferent to tax-related offences, despite the major progress made in making taxation a civil responsibility and fostering a tax culture in recent years. While this has improved the tax-related behaviour of citizens, there is still a lot of work to do until this type of behaviour is considered socially unacceptable and strictly punishable by law, as these are actions that not only affect the economy of a society but also blur its culture and values.

#### **IV. TAX HAVENS AND THE 1999 BANKING CRISIS IN ECUADOR**

It is important to remember that the adverse effect that tax havens have on Ecuador’s economy is nothing new. It dates back many years and helped to trigger one of the most difficult periods for Ecuador’s economy. This period is known as the “banking crisis”, and was one of the reasons why Ecuador gave up its currency.

In March 1999, a “banking holiday” was declared and financial institutions closed their doors for a week. This resulted in deposits

being frozen, companies going bankrupt, higher rates of suicide, older people losing their life savings, and increased unemployment, which in turn led to greater poverty and destitution. It also prompted the biggest wave of migration in the country's history.

The economic loss amounted to US\$ 8 billion, which was almost 40% of GDP, and the social losses were even greater.<sup>15</sup>

In 1999, international audit firms revealed that some of the biggest banks used offshore arms to carry out certain inappropriate practices. Banco Popular, for instance, “sold bad loans on the last day of the month to a non-banking subsidiary to hide its portfolio of non-performing loans”. Banco La Previsora “used its offshore offices to invest in properties but classified the investments as loans”.<sup>16</sup>

Permissive regulations had led to financial deregulation and liberalization, incentivizing inappropriate behaviour by the financial system and moral hazard, and legalizing offshore banking in tax havens on the argument that there was a need for greater financial integration in the international markets. This created the ideal environment for tax avoidance and evasion, generating “creative accounting” methods through pyramiding and making it easy to bypass regulations. Offshore banks were used to avoid regulations concerning transactions within a financial group and adjust the figures reported for technical capital. Offshore banking reached major proportions (two thirds of onshore assets,<sup>17</sup> which means that a large part of the country's wealth was invested in tax havens.

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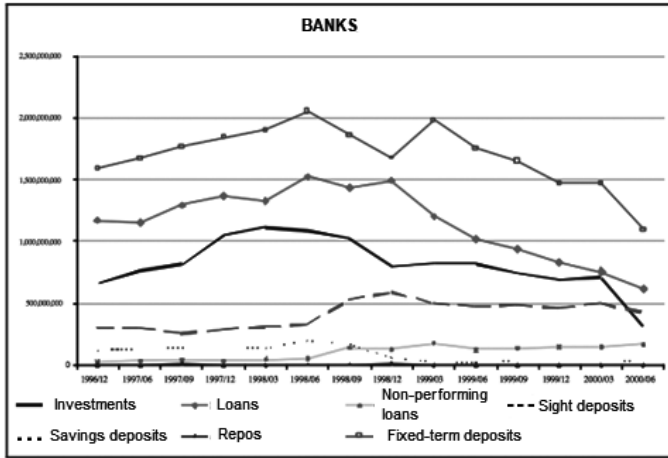
<sup>15</sup> “Tras las huellas de un atraco, Ecuador, 1999”. Available from [www.memoriacrisisbancaria.com](http://www.memoriacrisisbancaria.com).

<sup>16</sup> Pedro Páez Pérez, “Liberalización financiera, crisis y destrucción de la moneda nacional en Ecuador,” *Cuestiones económicas*, Vol. 20, 2004. Available from [https://www.bce.fin.ec/cuestiones\\_economicas/imagenes/PDFS/2004/No1/Vol.20-1-2004PedroPaez.pdf](https://www.bce.fin.ec/cuestiones_economicas/imagenes/PDFS/2004/No1/Vol.20-1-2004PedroPaez.pdf).

<sup>17</sup> Pedro Páez Pérez, “Liberalización financiera, crisis y destrucción de la moneda nacional en Ecuador,” *Cuestiones económicas*, Vol. 20, 2004. Available from [https://www.bce.fin.ec/cuestiones\\_economicas/imagenes/PDFS/2004/No1/Vol.20-1-2004PedroPaez.pdf](https://www.bce.fin.ec/cuestiones_economicas/imagenes/PDFS/2004/No1/Vol.20-1-2004PedroPaez.pdf).

“As a result of greater activity and growing market uncertainty, offshore deposits grew rapidly during this period, rising by around US\$ 1 billion, as shown in the graph below.”

**Figure 4: Main offshore accounts of Ecuadorian banks**



Source: Banco Central del Ecuador

“After the crisis, the percentage of impaired loans in the offshore arms of closed banks reached 90% and a large proportion of these loans were lost because of a lack of appropriate collateral and because of ghost borrowers”.<sup>18</sup> All of these bad practices were possible thanks to the secrecy, discretion and opacity offered by tax havens.

## V. TAX HAVENS AND THEIR IMPACT IN ECUADOR

Fighting tax havens is a moral and ethical duty, and Ecuador must ensure that its wealth does not leave the country and this does not cause another economic and financial crisis. As such, Ecuador has made fighting tax havens a policy of the State and not just of the Tax Authority.

<sup>18</sup> Pedro Páez Pérez, “Liberalización financiera, crisis y destrucción de la moneda nacional en Ecuador,” *Cuestiones económicas*, Vol. 20, 2004. Available from [https://www.bce.fin.ec/cuestiones\\_economicas/images/PDFS/2004/No1/Vol.20-1-2004PedroPaez.pdf](https://www.bce.fin.ec/cuestiones_economicas/images/PDFS/2004/No1/Vol.20-1-2004PedroPaez.pdf).

The Ecuadorian Tax Authority defines tax havens as jurisdictions that protect and promote harmful tax competition, attracting capital regardless of its origin, offering little or no transparency and having no other requirements of substance that need to be met for a company or transactions to be covered by its tax regimes.

In Ecuador, according to figures from 2016 tax returns, 50% of the share capital of companies considered as major taxpayers came from outside the country. In reality this is not a foreign investment but domestic investment that comes from outside the country, with 70% of this amount coming through tax havens.

The tax havens in which the largest numbers of shareholders in domestic companies are registered are: Panama, the Virgin Islands and Barbados.

**Table 1: Ranking of assets held by shareholders domiciled in tax havens**

Ranking	Tax havens	Proportion of total wealth in tax havens	Total for companies
1	Panama	54.7%	1,316
2	British Virgin Islands	13.0%	196
3	Barbados	12.3%	2
4	Cayman Islands	9.9%	31
5	Bahamas	4.0%	100
6	Bermuda	2.5%	23
7	Luxembourg	1.0%	19
8	Curaçao	0.9%	11
9	Belize	0.7%	31
10	Others	1.0%	111

Source: *Servicio de Rentas Internas del Ecuador*

According to information from the country's Inland Revenue Service, business groups based in Ecuador accounted for 37% of



total sales in 2016. Out of these business groups, 76% have foreign shareholders, of which 49% are located in tax havens, primarily Panama, the Virgin Islands and Barbados.

According to information from the Tax Authority, between 2014 and April 2017, US\$ 5,224 million left the country for tax havens. This does not include the money belonging to Ecuadorians that was already abroad and moved countries. This affects our economy, not only because taxes are not paid on a large part of these funds but also because it weakens the structure of the economy, as we live in a dollarized economy that needs to be able to keep a certain amount of dollars in the economy.

Strangely, the main reasons why money leaves the country are to pay down loans, to repay loans early and for collections outside the country. Regulations concerning the financial system are explained in section 6.7 below. Financial entities in tax havens can no longer use the domestic financial system to grant loans, and so outflows for these reasons should decline.

Based on information from the Tax Justice Network, Ecuador's tax authorities estimated that Ecuador lost US\$ 30 billion dollars in funds that ended up in tax haven between 1970 and 2010.<sup>19</sup>

It is not surprising that, even though it is a relatively small economy, Ecuador was ranked ninth in the top ten countries with intermediaries that operated with Mossack Fonseca,<sup>20</sup> based on information from the International Consortium of Investigative Journalists (ICIJ). Based on this information, there are 1,852 offshore entities connected to Ecuador. However, after further analysis the ICIJ revised this figure up to 2,114, with almost 60% of these offshore entities based in Panama.

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<sup>19</sup> James S. Henry, "The Price of Offshore Revisited – Appendix III – Key Charts" (Tax Justice Network, July 2012). Available from <https://www.taxjustice.net/cms/upload/pdf/Appendix%203%20-%202012%20Price%20of%20Offshore%20pt%201%20-%20pp%201-59.pdf>.

<sup>20</sup> Mossack Fonseca is the fourth largest law firm in the world. It provided advice on how to use tax havens for financial management purposes. Information on the firm was leaked in what is known as the Panama Papers.

**Table 2: Offshore entities connected with Ecuador and created by Mossack Fonseca by country of domicile**

Offshore country	Number of offshore entities created	% of holding
Panama	1,258	59.51%
British Virgin Islands	307	14.52%
Nevada	210	9.93%
British Anguilla	153	7.24%
Bahamas	66	3.12%
Seychelles	36	1.70%
Samoa	23	1.09%
Niue	18	0.85%
United Kingdom	11	0.52%
Costa Rica	8	0.38%
New Zealand	8	0.38%
Belize	5	0.24%
Uruguay	4	0.19%
Hong Kong	2	0.09%
Cyprus	1	0.05%
Unknown	4	0.19%
<b>Total</b>	<b>2,114</b>	<b>100.00%</b>

We have these figures thanks to the leak. Otherwise, the discretion and secrecy offered by tax havens would have been maintained. Tax havens are accomplices in multiple cases of corruption and abuse that have come to light as well as in crimes such as tax evasion, corruption, money laundering, etc. They also lead to cuts in government budgets that so need these resources to develop health

care, education, justice, etc. Furthermore, tax havens contributed to the economic and social crisis and have shirked their responsibilities, leading to another crisis – the ethical crisis.

From the controls that Ecuador's tax authorities have implemented for years now, it came to light that tax havens were being used to erode the tax base through the use of practices such as transfer pricing, undercapitalization and the simulation of transactions. Such practices have generated more than US\$ one billion in fines.

## **VI. CHANGES IN REGULATIONS IN ECUADOR**

Despite the adverse effects on the country's economy; and the difficulty of establishing fines for using tax havens, it was not until 2007 that Ecuador began tackling tax havens head on. The country made major regulatory and administrative changes that covered taxation as well as the financial – and even the political – system, with a view to discouraging capital flight and tax evasion through tax havens and limit the harmful effects it has on both the economy and society.

Under Ecuadorian law, all regulations concerning income tax, which is paid annually, come into effect in the year following publication of the amendment.

In late 2007, the first regulatory amendments were made with the adoption of the Tax Equality Act, which allows the tax authorities to strengthen their control processes and implement regulations that make it easier to control the misuse of tax havens. These changes came into effect in 2008.

The main changes in terms of anti-tax-haven regulations are analysed below and can be grouped as follows:

- 6.1 List of tax havens, jurisdictions with low tax rates, and preferential tax regimes.
- 6.2 Exemptions not applicable to tax havens, jurisdictions with lower tax rates and preferential tax regimes.
- 6.3 Non-deductible expenses relating to tax havens, jurisdictions with lower tax rates and preferential tax regimes.

- 6.4 Income tax rate
- 6.5 Treatment of oil, bananas and minerals
- 6.6 Tax withholding for payments to tax havens
- 6.7 Financial system regulations
- 6.8 Ethical pact
- 6.9 Other regulations: Residence, closely related parties, aggressive tax planning strategies, and lifting banking secrecy

### ***VI.1 List of tax havens, jurisdictions with low tax rates, and preferential tax regimes***

In the Tax Equality Act (*Ley Reformatoria para la Equidad Tributaria*) published in December 2007, the tax authority is given the power to issue a list of countries deemed to be tax havens.

As a result, in February 2008, resolution 182 was issued. This resolution has since undergone several amendments, but nevertheless has three key parts:

- 6.1.1 List of countries deemed to be tax havens;
- 6.1.2 Jurisdictions with low tax rates; and
- 6.1.3 Preferential tax regimes.

#### ***VI.1.1 List of countries deemed to be tax havens***

The Tax Authority drew up an initial list in 2008. It included 90 countries and jurisdictions considered to be tax havens or to have preferential tax regimes. This list draws on and complies with comparable legislative experiences in other countries and common practices at the global level.

Countries can be removed from the list if they enter into an effective double taxation agreement with Ecuador that contains clauses on the exchange of information and if their domestic legislation does not allow for banking, stock-market or any other type of secrecy regarding requests for information from the Inland Revenue Service and if they change their legislation to bring income tax rules in line with international guidelines. This would mean they are no longer classified as tax havens or preferential tax regimes.

Subsequently, the rules were changed so that a country can be removed from the list if it enters into a specific agreement on the

exchange of information even if it does not have a double taxation agreement with a clause on the exchange of information.

The list has been changed since it was first implemented in 2008. Firstly, Uruguay was removed from the list of tax havens in 2009 and the Canary Islands Special Zone in 2011. A double taxation agreement with an exchange of information clause was entered into with Uruguay. As for the Canary Islands Special Zone, it forms part of Spain, a country with which Ecuador already had a double taxation agreement with an exchange of information clause, and it was demonstrated that this zone was covered by the provisions of this agreement.

In 2015, resolution 052 was issued, which replaced resolution 182 issued in 2008 and recorded 87 countries and jurisdictions as tax havens. Amendments were made to remove Qatar, the Pacific Islands and Hong Kong from the list and to correct the reference to the now dissolved Netherlands Antilles.

In 2016, Trieste was removed from the list, as it is part of Italy, a country with which Ecuador has a double taxation agreement with a clause on the exchange of information and which does not have any harmful regulations.

Finally, in August 2017, a new resolution was issued to include Hong Kong<sup>21</sup> once again in the list, as talks with the Chinese territory to sign and effectively implement a specific agreement on the exchange of information did not come to anything. As a result, the current list contains 88 countries and jurisdictions, the details of which can be found on the Tax Authority's website.<sup>22</sup>

This mechanism has made it easier for taxpayers to apply rules concerning tax havens, since they have a list and any doubt concerning the countries and jurisdictions that should be treated as tax havens has been removed. In addition, the experience of the

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<sup>21</sup> This region is a special administrative region of China with a separate legal and tax system to that of China. Its tax system is based on territorial criteria, which means that only income from local sources is subject to tax. Factors such as residence and nationality are not relevant for tax purposes. Tax rates in Hong Kong are among the lowest in the world, which is why numerous foreign companies choose the city as the head office for their Asian operations (ICEX).

<sup>22</sup> Available from <http://www.sri.gob.ec/BibliotecaPortlet/descargar/558c426d-570a-4655-8313-a59cc46db267/Listado%20de%20Paraisos%20Fiscales.pdf>.

list was positive because once it had been issued, countries like Spain (Canary Islands) and Uruguay came forward and provided information, making it possible to make changes to the list.

### ***VI.1.2 Jurisdictions with low tax rates***

Many territories that are part of a country have different tax regimes to the rest of the country. This means that the country as a whole cannot be considered a tax haven, but the territory in question can. As a result, and considering that the tax framework can change every day at a global level, resolution 182 issued in 2008 stipulated that tax havens were those countries and jurisdictions with an effective rate of income or similar tax below 60% of the rate applied in Ecuador, i.e. those countries and jurisdictions with a tax rate of below 15% up to 2010 and as follows since 2011:

**Table 3: Income tax rates to classify countries and jurisdictions as tax havens**

Year	Corporate Income Tax Rate in Ecuador*	60% of tax rate
2010	25%	15.00%
2011	24%	14.40%
2012	23%	13.80%
2013	22%	13.20%
The Production Code issued in December 2010 reduced the corporate income tax rate by one percentage point a year, reaching 22%, which is the rate currently in force.		

This approach allowed for some flexibility, since control processes could be used to treat transactions with jurisdictions with low tax rates as with tax havens without having to issue a new list of tax havens.

This approach remained practically unchanged in resolution 052, issued in 2015.

### ***VI.1.3 Preferential tax regimes***

Preferential tax regimes are legal forms and as such are independent of the territory itself.

In resolution 182, issued in 2008, preferential tax regimes were considered tax havens and were therefore included in the countries and jurisdictions listed in these regulations.

Later on, in 2015, resolution 052 distinguished between these two concepts in different articles, setting as the criteria for being considered a preferential tax regime the lack of substantial economic activity or a low tax rate (less than 60% of the rate in effect in Ecuador).

In 2016, through resolution 440, the definition of a preferential tax regime was changed. It now sets out both specific preferential tax regimes and general conditions for regimes to be deemed as such.

The following types of **specific** regimes are included:

1. Those granted only to foreigners and not to nationals, which is known as “ring fencing”;
2. Those that allow companies to have bearer shares or nominee shareholders without the identity of the beneficial owner being known;
3. Those that make tax-exempt any income from activities developed outside the country involving goods that do not originate in or are not destined for the territory where the tax regime is established. In other words, when the economic activities are not conducted in that location.
4. Those where it is possible to legally create a company without any obligation to declare the company to the tax authority in that country.

In terms of **general** criteria, at least two of the following conditions must be met for a regime to be classified as a preferential tax regime and deemed to be a tax haven:

- a) lack of economic substance;
- b) effective rate of income or similar taxes below 60% or unknown;
- c) lack of transparency and no effective mechanisms for exchanging information;
- d) companies are allowed to have bearer shares or nominee shareholders.

Finally, in August 2017, resolution 433 was issued, which replaces resolution 052, amending the article relating to preferential tax regimes and expressly including regimes identified in the Netherlands, the UK, New Zealand and Costa Rica.

**Table 4: Preferential tax regimes by country, pursuant to resolution 2015-52**

DESCRIPTION	Investment companies not paying income tax	Tax rulings	Innovation box	Companies with nominees and where the beneficial owner is not known	Trusts	Not registered with the tax authorities
NETHERLANDS	X	X	X			
UK			X	X		
NEW ZEALAND					X	
COSTA RICA						X

In conclusion, Ecuador treats as tax havens:

- **Tax havens themselves:** 88 countries in the list available at the Tax Authority's website: [www.sri.gob.ec](http://www.sri.gob.ec);
- Those **jurisdictions** that it considers to have a low tax rate, i.e. a rate that is less than 60% of the income tax rate in effect in Ecuador;
- Specific **preferential tax regimes** and those regimes that meet two of the four general criteria, such as those



identified in the Netherlands, UK, New Zealand and Costa Rica, as mentioned above.

***VI.2 Exemptions not applicable to tax havens,  
jurisdictions with lower tax rates  
and preferential tax regimes***

In the Tax Equality Act issued in December 2007, an amendment was made to how income from outside the country is treated. Up to that fiscal year, income from other countries had been included in overall income and a tax credit was recognized for the income tax paid abroad, up to a maximum amount corresponding to the tax paid on the income earned abroad. Since 2008, such income has been considered tax-exempt income subject to tax in another country. However, this does not apply to income earned in tax havens, and even when tax has already been paid in the tax haven, the income is considered part of the taxable income in Ecuador and no tax credit is recognized for the tax paid in the tax haven.

In addition, Ecuador has an overseas remittance tax, which, as its name suggests, is a tax (5%) on funds that leave Ecuador. This was adopted to prevent dollars from exiting the economy and to strengthen the dollarization of Ecuador. This tax is levied on any funds leaving the country, except for certain transactions stipulated by law. One type of transaction that was exempt from this tax until 2007 was the payment of dividends. However, from 2008, this was limited to dividends that are sent to countries not considered to be tax havens, jurisdictions with low tax rates or preferential tax regimes. Dividends transferred to tax havens are subject to this 5% overseas remittance tax.

Following a series of cases involving the misuse of trusts, the tax benefits for trusts were restricted in the reform that was issued in 2014 and came into effect in 2015. Under this reform, income from trusts that do not develop business activities or have ongoing business operations are exempt from tax. However, this does not apply when one of the founders or beneficiaries is a natural person or company that resides or is based in a tax haven or a jurisdiction with a low tax rate.

### ***VI.3 Non-deductible expenses relating to tax havens, jurisdictions with lower tax rates and preferential tax regimes***

Under the 2007 reform, payments relating to international commercial leasing arrangements are not tax-deductible if they are made to natural persons or companies that reside in tax havens. It is important to note that both national and international commercial leasing arrangements had been misused to create tax deductions and to take advantage of accelerated depreciation without needing to request authorization from the tax authorities. Under Ecuadorian regulations, it is possible to deduct the value of the maximum depreciation accepted for taxable property relative to commercial leasing. However, when payments are made to tax havens, the expense cannot be deducted even if the other conditions are met.

There are also restrictions on tax deductions relating to interest paid on loans outside the country and granted by non-financial institutions,<sup>23</sup> indirect expenses<sup>24</sup> and bonuses<sup>25</sup> when they are made with closely related parties (see section 6.9.2).

### ***VI.4 Income tax rate***

In the reform made in late 2014, which came into force in 2015, the income tax rate was set at 25% for companies with shareholders, partners, participants, founders, beneficiaries or equivalent residing or established in tax havens or jurisdictions with a low tax rate and with a direct or indirect joint or individual holding at or above 50% of the share capital. If the holding is less than 50%, the rate of 25%

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<sup>23</sup> For interest payments to be deducted, the external debt must not exceed 300% of total assets when the borrower is a company and 60% of total assets when the borrower is a natural person. Interest payments on amounts exceeding this threshold are not deductible, although 22% of the total interest paid must be maintained. There is no limit if the debt is with financial entities, even if they are located in tax havens.

<sup>24</sup> Up to 5% of the income tax base plus the value of such expenses can be deducted. 5% of total assets in the preoperative period. A corresponding amount must be withheld at source.

<sup>25</sup> Up to 20% of the income tax base plus the value of such expenses can be deducted. 10% of total assets in the preoperative period. A corresponding amount must be withheld at source.

is applied to the proportion of the tax base that corresponds to the shareholders with a holding in tax havens, jurisdictions with low tax rates and preferential tax regimes.

It is worth noting that the Production Code issued in late 2010 reduces the corporate income tax rate by one percentage point a year, reaching 22%. The rate at the time was 25%. Under the reform, companies with shareholders domiciled in tax havens pay a higher rate.

The rate of 25% is also applied when companies have not made inquiries as to the name of the natural person who is the beneficial owner of the company.<sup>26</sup>

### ***VI.5 Treatment of oil, bananas and minerals***

Oil, bananas and minerals are important products for the country's economy and together represent around 50% of total exports and are the source of major inflows of funds into Ecuador.

Given their importance, the Tax Authority issued resolution 531 in 2016, which sets out technical measures and methods to prevent the abuse of transfer pricing. These measures involve determining the comparable non-controlled price as a method for determining the transfer price, as well as the conditions, periods, intermediary margins and adjustments that have to be considered for these prices in order to be used for the comparison.

These measures are applied when transactions are conducted with related parties domiciled in tax havens, jurisdiction with low tax rates and preferential tax regimes, or when an international intermediary is used and that intermediary does not reside in Ecuador or in the country to which the goods are being exported.

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<sup>26</sup> Under resolution 536, issued on 28 December 2016, listed companies are not required to provide details of shareholders that own less than 2% of the share capital. For non-profit organizations and investment funds, minimum holdings subject to reporting are also set out. The requirements to report to the end level applies to those entities whose owners or beneficiaries with voting rights or members of governing bodies are companies that are not permanently based in Ecuador.

### **VI.6 Tax withholding for payments to tax havens**

Tax withholding has been used to discourage the use of tax havens.

The table below shows how payments to countries considered to be tax havens, jurisdictions with low tax rates or preferential tax regimes are treated compared with countries that do not fall within these categories. It clearly shows Ecuador's intention to levy taxes on income that is sent to tax havens at a higher rate than that paid by natural persons in the country (35%). This is based on the assumption that in the tax haven there is an Ecuadorian who should be paying tax in Ecuador.

**Table 5: Comparative rates of withholding tax**

Comparison of Withholding Tax Paid on Payments From Ecuador to Tax Havens, Jurisdictions with Low Tax Rates and Preferential Tax Regimes and to Countries Not Considered as such

PAYMENT TYPE	TAX HAVEN	NOT TAX HAVEN
Dividends (when issuing entity does not apply exemptions)	10%	0%
Dividends (when issuing entity applies exemptions)*	35%	0%
Insurance premiums	35%	22% ***
Foreign remittance withholding tax**	35%	22%

\*Not applied to those with agreements with a public-private association. 10-year exemption

\*\*Except countries with an agreement that applies the provisions of said document

\*\*\*22% applied to 25-50% of the value, while the rate is 100% for tax havens

### ***VI.7 Financial system regulations***

In 2012, further efforts were made to fight tax havens and discourage financial institutions from investing in tax havens. A tax on assets held abroad had already been introduced in 2009; it must be paid by all financial institutions on investments made outside the country. The tax rate was then increased from 0.08% to 0.25% for investments made abroad and 0.35% for investments in tax havens. This measure clearly encourages financial institutions to repatriate funds to Ecuador, and was supported by other measures taken by the Monetary and Financial Regulation Authority.

The Financial Code was also issued; it sets out certain rules for financial institutions and limits their relations with tax havens as follows:

- The main domicile of foreign financial entities cannot be a tax haven.
- Financial entities cannot be shareholders in financial entities domiciled in tax havens.
- Shareholders with an interest in financial entities (more than 6% of the capital) cannot be shareholders in financial entities domiciled in tax havens or jurisdictions with low tax rates.

The Monetary and Financial Regulation Authority has issued various resolutions that set out the following rules:

- Direct and indirect shareholders in private financial entities cannot be located in tax havens.
- Resolution 335 of 23 February 2017 stipulates that financial institutions in Ecuador must end any agreement that allows foreign financial institutions to grant credit or raise funds. It is important to point out that most transactions from outside the country were conducted through tax havens, which is why the possibility of using banks in tax havens for investment or credit operations through domestic banks has been limited by law.
- Regulation 371 prevents public and private financial institutions from conducting credit operations with and buying lending portfolios granted to natural and legal persons domiciled in tax havens or jurisdictions with low tax rates.

These provisions were implemented to help keep funds in the country's economy. The Monetary and Financial Regulation Authority stipulated that financial entities must meet a 60% domestic liquidity ratio, which means that 60% of the financial resources of financial institutions must be held in the country. Only investments – and not loans – made outside the country were included in this ratio, which meant that various financial entities used loans to other entities located in tax havens to circumvent the provisions and hold funds outside the country. Through this mechanism, loans were passed onto subsidiaries held outside the country by financial entities located in Ecuador.

Loans granted before the regulation was issued cannot be renewed, refunded or restructured and have to be cancelled on the original terms of the transaction.

### ***VI.8 Ethical Pact***

The “Ethical Pact” is a pioneering initiative, as it was the first referendum in a western democracy on the issue of tax havens. The people were asked the following question:

*“Do you agree that those wishing to stand for election or serve as a public official should be prohibited from holding assets or capital of any type in tax havens?”*

In response to this question, 55.12% replied yes, and on 8 September 2017 the “Act implementing the popular vote held on 19 February 2017” (*Ley Orgánica para la Aplicación de la Consulta Popular Efectuada el 19 de Febrero del 2017*) was issued. It prohibits anyone holding or standing for an elected position or serving as a public official in the public sector if they directly or indirectly own assets or capital in jurisdictions or regimes considered to be tax havens.

Those holding assets in such jurisdictions were given until 6 March 2018 to transfer them to unrelated third parties. The transfer is not valid if it is to relatives within the fourth degree of consanguinity or second degree of affinity or to related third parties.

This initiative made international news, such as the article by Marcelo Bustos for BBC World on 20 February 2017 entitled “Ethical

Pact: three reasons why the referendum on tax havens in Ecuador is important for other countries”.

*“It’s an idea that should be repeated in other countries. It will help to prevent public officials from hiding the money they receive in bribes and also makes it difficult for them to be part of a government if they have undeclared assets in a tax haven”, Bustos told BBC World.*

Although a ban at this level now exists for those in the public sector, this does not guarantee that it will be effective. However, it is a major step forward in addressing corruption and its means and raising social awareness regarding the role of public officials.

It is important to highlight that there are exceptions to this law for officials posted in a country or jurisdiction that is considered to be a tax haven, for students and interns in these jurisdictions that wish to stand for an elected position, and for candidates or members of parliament that represent foreign voters and reside in a country or jurisdiction considered to be a tax haven.

***VI.9 Other additional regulations: Residence, closely related parties, aggressive tax planning strategies, and lifting banking secrecy, and the Global Forum***

***VI.9.1 Residence***

Important rules were adopted in 2014 and came into effect in 2015 concerning the tax residence of natural persons, as prior rules could be easily bypassed.

The following rules have now been set out:

(a) Anyone who spends one hundred and eighty-three (183) calendar days or more, in a row or otherwise, in Ecuador or on board an Ecuadorian ship during a fiscal year, including sporadic absences (i.e. not exceeding 30 days), is considered a tax resident of Ecuador.

(b) The 183 days can be spread over two fiscal years unless the person’s tax residence for the corresponding period is in another country or jurisdiction.

If the tax residence is declared to be in a tax haven or jurisdiction with low tax rates, the individual must prove that they stayed in that country or jurisdiction for at least one hundred and eighty-three (183) calendar days, in a row or otherwise, during the fiscal year in question. Otherwise, the individual remains a tax resident of Ecuador for the following four fiscal years.

(c) An individual is considered a tax resident of Ecuador when the majority of their assets and income is directly or indirectly recorded in Ecuador.

(d) Finally, to remove any doubt, an individual is considered to be a tax resident of Ecuador if they do not spend more than one hundred and eighty-three calendar days, in a row or otherwise, in any other one country or jurisdiction during the fiscal year, and their closest family ties remain in Ecuador.

### ***VI.9.2 Closely related parties***

The Act issued in late 2008 included a definition of closely related parties. Among other factors, it states that shareholders and directors are considered closely related parties of companies with which transactions are conducted and that are domiciled, founded or located in a jurisdiction with low tax rates or a tax haven. This definition is crucial because it provides for a series of rules that limit and restrict tax benefits and deductions when transactions and operations are conducted with closely related parties, as is the case with debt limits, indirect expenses and bonuses.

### ***VI.9.3 Aggressive tax planning strategies and lifting banking secrecy***

In 2016, following the discovery of certain cases of fraud published by the ICIJ, known as the Panama Papers, and the role played by tax advisors and major law firms in these cases, legal reforms were made to lift the secrecy surrounding information that helps to identify ownership and operations of residents of Ecuador with third parties located in tax havens, as well as aggressive tax planning practices and the advisors, promoters, designers and consultants involved in these practices.



Under these regulations, information on business groups' tax behaviour concerning offshore entities is published on the internet. In addition, promoters, advisors, consultants and law firms are required to inform under oath the Tax Authority of the creation, use and ownership of companies that have Ecuadorian beneficial owners and are located in tax havens or jurisdictions with low tax rates. If this provision is not complied with, a fine equivalent to up to ten times the basic amount not subject to income tax (for 2017, the amount would be up to US\$ 112,900) is charged, without prejudice to the criminal liability that may have been incurred.

Based on this article, a series of requests were made to the main law firms that create offshore companies, and the information served as the basis for the Tax Authority's planning and execution of control processes.

**Table 6: Use of offshore entities based on information from law firms**

Use of offshore entities	Total offshore entities created
Holding (shares or other assets)	160
International trade	72
Inactive or liquidated (never used)	43
Wealth	25
Foundation	2
Business administration	1
Sending money	1
Legal representation	1
Total	305

#### ***VI.9.4 Lifting banking secrecy for the Tax Authority***

Another important step was that on 23 December 2009, banking secrecy was lifted for the Tax Authority, which means that financial institutions are required to report bank information on transactions conducted between Ecuador and tax havens.

#### ***VI.9.5 Global Forum***

While the actions taken by our country are important, they need to be combined with essential and timely information if we are to truly fight tax havens. This is why Ecuador requested to be part of the Global Forum, which is currently in the peer review stage concerning compliance with international standards by countries and jurisdictions.

All countries have a duty to transform words into action in order to change the view that measures taken at the international level have been timid, superficial and with little impact. Ecuador has set a clear example. Our action can be compared to that of the story of the boy who put the starfish back in the sea – although not all of the starfish could be saved, it was worth it because of the ones he did save.

# CHAPTER 10

## GENDER, TAX REFORM AND TAXATION

### COOPERATION ISSUES: NAVIGATING EQUITY AND EFFICIENCY UNDER POLICY CONSTRAINTS<sup>1</sup>

Mariama Williams

#### I. INTRODUCTION

Fiscal policy has been a quite well researched and discussed topic in the context of gender equality and women's empowerment. In this struggle for gender justice, feminist economic and policy analysis and group activism has rightly focused upon bringing to light the gendered nature of fiscal expenditures as well as the extent to which governments allocate resources designed to promote gender equality. However, there has been much less literature and organizational activities focused on recognizing and detailing how the discriminatory impacts of tax collection measures may adversely impact gender equality and women's economic advancement in developing countries.

Fiscal spending policy can be fine-tuned to help support broad-based initiatives as well as targeted gender equality-oriented *interventions* such as those directly designed to promote *gender equality*. These include *funding programmes and projects* that provide skills to women and girls to help them navigate economic and labor market challenges and for programmes that seek to address historical gender-based discrimination and violence against women (Grown et al., 2006 and Williams, 2007). Non-targeted gender equality (NTGE) projects and programmes are those that seek to address the

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<sup>1</sup> This chapter was previously published as South Centre Tax Cooperation Policy Brief No. 9 (September 2019).

broader environment, such as community-based infrastructure and activities that help to reduce the burden of care often experienced by women (Grown et al., 2006). The growing and maturing work on gender responsive budgeting (GRB) has been the result of decades-long activism that has focused on ensuring and enhancing such fiscal spending policy initiatives.

While gender-oriented analysis and activism regarding tax-related policies were given less attention in previous periods, this is changing rapidly. Even as the post-2030 agenda emphasizes domestic resource mobilization as being critically dependent on optimizing tax revenues, the present era's "taxing for growth" initiatives are being driven by reduction of corporate taxes. This inevitably raises questions of tax equity and efficiency, and these concerns are being discussed with ever-increasing urgency. Optimizing tax revenues is vitally important for promoting development and addressing critical gaps in areas such as health, education, basic infrastructure, access to modern energy services, electrification and water. Hence, developing-country governments are ramping up efforts including shoring up their tax base, reforming tax laws and increasing revenue collection efficiency. Unfortunately, in far too many cases, the shift is towards regressive tax measures such as value-added tax (VAT) or goods and services taxes (GST) instead of raising corporate, property, other income and capital gains taxes. Additionally, efforts have turned to imposing taxes on the informal economy, with adverse implications for many women-owned micro- and self-help organizing activities.

Furthermore, fiscal de-centralization has compelled many local governments to rely increasingly on their own sources of revenues. These often include implementation and collection of various points-of-service payments such as user fees, so-called market and informal taxes or rents (taxes outside the statutory laws) which are burdensome to the poor (Joshi, 2017 and Capraro, 2016). While not strictly taxes, in the classical sense, these forms of fee collections have a tax-like effect and often substitute for "taxes". These include protection payments to local police and vendors paying to use

sidewalks (Joshi, 2017). Thus individuals and households are forced to pay local governments, or non-state actors on behalf of local governments in order to access services (Joshi, 2017). In particular, women and girls are adversely affected by these distributional effects as their small businesses are the main users of sidewalks and other informal market set-ups. Furthermore, the services they provide are important for the functioning of the households and are paid by the households (Joshi, 2017).

As developing countries increasingly resort to VAT/GST combined with the growing awareness of issues such as capital flight and illicit financial outflows that rob their domestic treasuries, developing countries are expressing a strong and growing interest in taxation and justice and tax and gender issues. Developed countries have made some attempts at reforming their tax codes to eliminate some of the more pernicious forms of gender biases. These reforms were spurred in part by a 1984/85 European Communities (EC) report on income taxation and equal treatment for men and women and a subsequent 1997 International Monetary Fund (IMF) paper on gender biases in tax systems. While a few developing countries have yet to make strides to enact similar measures, slowly and over time, some work on these issues has been taking place in selected countries throughout Africa, Asia, Latin America and the Caribbean as part of taxation reform efforts.

Overall it is therefore important to appreciate the full nature and extent of these trends and to better understand to what extent actions to promoting gender sensitivity and responsiveness in tax systems help to expand the tax base as well as to explore whether to (en)gender<sup>2</sup>

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<sup>2</sup> The word (en)gender or en-gender or engender (used in this context) is taken to mean “to integrate gender perspectives and women’s empowerment considerations into...”(for example, *(En)Gendering International Development*). Usage of this word can be found in the 2001 policy research paper *Engendering Development* by Mason and King, for Oxford University Press and the World Bank. This is different from the 14<sup>th</sup> century usage of the word to mean “propagate” or “procreate.” See <https://www.merriam-webster.com/dictionary/engender>.

tax policy in developing countries. These efforts in turn, may be constrained by tax breaks, corporate tax reduction agreements<sup>3</sup> and the rules of international financial and trade/investment agreements. Ultimately, there is the issue of whether adverse gender effects of tax laws may undercut programmes geared towards promoting gender equality on the government expenditure side (Joshi, 2017) and to what extent tax reform, including international cooperation, takes into account women's voice and visibility in tax administration matters.

This chapter provides a brief survey of the policy literature on gender and taxation issues and considers how these issues are relevant to and are being taken on board in developing countries' tax (reform) policies as well as with regard to regional and international tax cooperation.

Section 2 briefly summarizes the current thinking on gender and taxation from the points of view of feminist economics.

Section 3 presents an overview of how this issue is implemented at the policy level in both developing and developed countries, linking national tax structure and public policy on gender justice. Section 4 rounds out the analysis with selected snapshots from developing countries.

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<sup>3</sup> Project-specific legal regimes known as Host Government Agreements (HGAs). As argued by Hildyard and Muttit (2006), these mechanisms provide companies with effective control over the legislations and regulations that apply to their activities and require states to compensate them for any new laws that affect corporate profits (Hildyard and Muttit, 2006, p. 2). These complement existing and evolving older legal instruments (developed in oil, gas and extractive industries in the 1960s) called Production Sharing Agreements (PSAs) with new or tightened conditions and control over laws and legislations in the sphere of activities of these companies as well as over the development of the host state's natural resources (Hildyard and Muttit, 2006). Furthermore, as noted by Hildyard and Muttit, through stabilization clauses (nested in HGAs and PSAs) governments agree to compensate concessionaires for changes in legislation that adversely affect their business.

Sections 5 and 6 briefly explores the relation between tax justice and gender justice from the standpoint of illicit financial flows/ tax avoidance and evasion and highlights issues in gender and tax cooperation.

## II. GENDER AND TAXATION FROM FEMINIST ECONOMICS POINTS OF VIEW

The area of revenue and sourcing—tax policy and tax code and tax administration— and its role in steering and allocating resources, including labor, and its gendered dimensions are now widely discussed. This has been heightened with a renewed focus on the advocacy areas of capital flight,<sup>4</sup> tax avoidance<sup>5</sup> and illicit financial flows which have been documented to have a serious impact on the social and economic development of developing countries.<sup>6</sup> These

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<sup>4</sup> Capital flight is more widely discussed in the literature. It generally signifies financial transfers taking place under the portfolio choice model for reasons of profit making or for fear of political risks: “Generally, capital flight is understood as the movement of funds abroad in order to secure better returns, often in response to an unfavourable business climate in the country of origin.” (UNECA, 2013 cited in Herkenrath, 2014). But Ndikumana (2013) debunks this and argues that the main reasons for continuing capital flight are illicit motives such as tax evasion and the concealment of corruption. In a 2014 paper, he notes that “*studies that use econometric analysis to uncover a relationship between capital flight and indicators of risk-adjusted returns to investment in the case of African countries find no conclusive evidence for the portfolio choice motive [...]. This leads to suspect that to a large extent capital flight is driven by illicit motives. Therefore, it cannot be addressed solely by relying on policies aimed at raising the domestic return to investment in African countries*”(Ndikumana and Boyce (2003) and (2011), cited in Ndikumana, 2014, p. 14).

<sup>5</sup> Tax avoidance includes such quasi-legal activities as intra-firm profit shifting, whereby transnational corporations engage in so-called aggressive tax avoidance, including the international transfer price regime and exploitation of regulatory lacunae in national legal systems (Herkenrath, 2014).

<sup>6</sup> Herkenrath (2014) defines Illicit Financial Flows (IFFs) as “— cross-border capital movements for the purposes of concealing illegal activities and evading taxes — pose major challenges to developing countries”. See also: OECD, 2013 and World Bank, 2012. The Global Financial Integrity (GFI) research institute describes IFFs simply as “cross-border transfers of funds that are illegally earned, transferred, or utilized” (GFI, 2013a).

outflows also constrain developing countries' fiscal and policy space (due to loss of public revenues), impeding efforts to respond to internal demands (both for public and private investment and for infrastructure building) and can contribute to the weakening of state institutions, thereby increasing corruption and rent-seeking behavior (Herkenrath, 2014; Ndikumana, 2014; OECD, 2013). In addition to the draining effects of these outflows, developing countries must also struggle to meet increasing international obligations with regard to social and economic development, and environmental and climate issues.

The tax revenue leakages from capital flight, tax avoidance and illicit financial flows all have social, environmental and economic and equity costs: they limit the fiscal space available to a government to carry out its core mandate of economic and social development. Governments require public funds to address poverty eradication, fund infrastructures, ensuring social protection and the availability of education, health care and affordable access to clean water and modern energy services to its population, especially the poor. Adequate and growing revenues are also important and necessary for promoting gender equality and women's economic empowerment.

In particular, for developing countries, these tax leakages and illicit financial flows hamper a government's ability to promote and ensure human rights—civil, political, economic, social, and cultural, and the right to development, including the provision of essential public services. These outflows heighten the issue of equity (whether the tax system is fair to everyone) and whether the tax enhances or diminishes the overall welfare of those who are taxed as well as efficiency loss of the functionality of the tax system (Tanzi and Zee, 2001).<sup>7</sup>

In the face of declining trade and other taxes (due to trade liberalization and neo-liberal approaches to tax reform promoted

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<sup>7</sup> These definitions of equity and efficiency with regard to tax are drawn from Tanzi and Zee (2001).



by the International Financial Institutions, such as the IMF and the World Bank), there continues to be rising demand for indirect taxes as a significant source of revenue streams for governments in developing countries. These sources of revenue have social and gender-equity dimensions, particularly in developing countries where a large proportion of government revenue accrues from non-income taxation.

In her 2014 report, Magdalena Sepulveda Carmona who was the Special Rapporteur on Extreme Poverty and Human Rights argued that fiscal policy, and particularly taxation policies, are a major determinant in the enjoyment of human rights. She underscores that “taxation is a key tool when tackling inequality and for generating the resources necessary for poverty reduction and the realization of human rights, and can also be used to foster stronger governance, accountability and participation in public affairs”. Carmona also argues that the principles of non-discrimination and equality as well as the duty of international cooperation and assistance should inform taxation policies at the global and national levels. Carmona’s contentions go straight to the heart of the issue, namely how justice and equity must be addressed in any taxation reform. This is certainly the starting point of feminist economists and gender experts who have begun focusing more attention on arguing for gender justice in the area of tax reform and tax cooperation. The political economy of gender as it relates to the theme of gender and taxation is grounded in the following three pillars of analysis.

First, women are the predominant, responsible party for social reproduction, broadly including care work (including housework, the collection of water, firewood, etc.)<sup>8</sup> and socialization of

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<sup>8</sup> Care work involves the direct care of persons – such as feeding and bathing a young child – as well as the domestic tasks that are a precondition for caregiving, such as preparing meals, cleaning sheets, purchasing food, and collecting water and fuel. Care can be unpaid – carried out for one’s own family or friends without any explicit monetary reward. It can also be paid in being performed, for example, by nannies, domestic workers, nurses, or carers in homes for older people (Esplen, 2009).

children and the care of the elderly or infirm (Laslett and Brenner, 1989). Feminist economics focuses attention on the unequal gender relations and the gendered division of labor in these social relationships and how they affect economic outcomes. A significant aspect of this analysis is the identification of the care economy as the country's foundation of social and economic organization (and indeed the global economy). Social reproduction is the bedrock of human development and human capital formation; thus the household economy is inextricably woven into the economics of production, productivity and growth.

The United Nations (UN) High-Level Panel on Women's Economic Empowerment makes the empirical argument that globally women perform 2.5 times more unpaid care and domestic work than men and that this work is valued at about US\$ 10 trillion or 13% of global gross domestic product (GDP) per year (UN, 2017). Women's and girls' time are constrained by these activities, lessening their involvement in other productive, income-earning activities and/or taking advantage of educational opportunities; they hence suffer from time poverty which may result in decreased well-being and adverse health outcomes (Hirway, 2015; Sepúlveda, 2013 and; Antonopoulus, 2009).

Taxation policies can help to decrease these effects by promoting resource flows for public spending on services such as water, sanitation and health care. Where this does not occur, girls and women must fill the gaps in public services with unpaid or low-paid care work (Donald and Moussie, 2016). This contributes to the infamous double burden of unpaid and paid work performed by women that subsidizes the monetized economy (Hirway, 2015 cited in the UN Secretary-General's (SG) High-Level Panel on Women's Economic Empowerment Report 2017).

Second, women's continuing and pervasive lack of economic equality and access to tangible and intangible economic and social resources continues to be a driving factor behind their lack of

economic advancement. A tax system that does not address these conditions by developing and implementing ameliorative measures leaves women further disadvantaged. The World Bank's 2016 Report on Women, Business and Law stated that of 173 economies surveyed, 155 have at least one law impeding women's economic empowerment (World Bank, 2015). The UN SG's High-Level Panel on Women's Economic Empowerment 2017 report flags that globally, women lack access to tangible (real estate, farmland, housing/building) and intangible economic and financial assets (bank accounts, access to credit, etc.) and that women are paid twenty-four percent less than men; around the world, forty-two percent of women and girls are outside the financial system (Demirguc-Kunt et al., 2014). The Organisation for Economic Co-operation and Development (OECD)'s Social Institutions and Gender Index (SIGI) 2014 edition highlights that women have equal ownership, use and control of properties in only 37% of 160 countries and the United Nations Environment Programme (UNEP)'s Global Gender and Environment Outlook (GGEO) report 2016 flags that 4% of countries have laws that prevent women from owning and controlling property (UNEP, 2016).

Third, furthermore, the persistent wage discrimination and disparities in working conditions and remuneration prevent women from accruing the income and assets that are important for promoting economic empowerment. The UN SG's High-Level Panel on Women's Economic Empowerment reports that globally women are paid 24% less than men. Due to gender biases, women continue to predominate in the informal sector with its precarious working conditions and low pay. Women also tend to be clustered in low-productivity and low-wage (and in some cases, unpaid) sectors of the agricultural and informal economy. Women in the labor force are also limited in terms of access to promotion and access to jobs with "workplace authority" in terms of operation and personnel functions which are on the frontline of managerial positions.

As a result of these three-pillar analyses, feminist economists argue that tax and gender is important for improving the substantive

equality for women (Joshi, 2017 and Lahey, 2018). The feminist political economy approach is increasingly linked to the advocacy around tax justice. Feminist scholars and activists are therefore focusing more of their efforts in analyzing and highlighting how tax laws shape the lives and overall economic empowerment of women and girls. In addition, attention is being focused on the impact of women's and men's access to property, income and public services. More specifically, economists are scrutinizing the nature of the unit of taxation, the types of taxes and their distributional effect on women and men. As a result, there has been the development of a call for having a gender sensitive tax code and policy; and gender responsive tax reform and tax cooperation, including taxing for sex equality and structural economic equality measures and ensuring an equitable tax base.

### **III. WHY IS GENDER AND TAXATION IMPORTANT?**

Taxation codes, regulation, the treatment of the tax payer, allocation of consumption taxes, etc. — the design of tax system— are not gender neutral and may have explicit biases that disadvantage one gender over another. Tax policies and how they are implemented also include effects on decisions regarding the nature and scope of employment, asset distribution, wealth accumulation, well-being/welfare (for example, in the case of divorce) as well as overall distributional impacts (distribution of income between women and men).

As regards the labor market, the literature shows that discrimination in personal income taxation, for example, directly affects labor supply and other behaviors. This is so, for example, when a higher marginal tax rate is applied to the lower-wage earner's income in a joint-filing income tax regime. Since, in many cases, it is the women's income that is so often adversely affected, research shows that some women may find it not at all beneficial to work, especially if the trade-off is higher costs for child-minding, either through day care/crèche and/or other out-of-pocket expenditures.

This may therefore discourage female labor force participation (see for example, European Parliament 2019a/b; IMF, 2018; and Dabla-Norris and Kochhar, 2019).

Exploration of the deep equity and fairness issue in this area with regard to gender was first broadly highlighted at the policy level in the 1984/5 European Commission paper, which persuaded some Member States to switch to an individual taxation system. It called for a fully independent taxation system with a view to achieving equal treatment of men and women, or at least, in order to allow a separate assessment as an option. Since then, many global governance institutions such as the IMF (see Stotsky 1996; 1997; and 2016), the World Bank (2012), the Commonwealth Secretariat (see Barnett and Grown, 2004) and the International Development Research Centre (IDRC) (see Grown and Valodia, 2010) have been paying attention to the subject. However, international non-governmental organizations (NGOs) such as the Tax Justice Network have been the most ardent advocates on this issue. Their work culminated in the *Bogota Declaration on Gender and Tax Justice 2017* agreed to by feminist economists and gender advocates in a meeting on Gender and Tax Justice in Bogota, Colombia in 2017 (<https://bit.ly/2lXULWm>).

### ***III.1 Issues arising in the conceptual and methodological debates and discussions on gender and taxation policies***

The recognition and acceptance of the link between gender and taxation as well as the fact that tax policies have gender discrimination and biases, which began in earnest in the 1980s, have been increasingly empirically validated (Barnett and Grown, 2004; Birchall and Fontana, 2015; GTZ, 2015 and Lahey, 2018). Many countries have begun to revamp and reform their tax systems to eliminate explicit gender discriminatory provisions, in particular, with regard to personal income taxes, though multiple forms and types of implicit gender biases may remain.

All national tax systems have the same basic traditional categories: direct taxes on income and wealth (personal taxes, corporate taxes and wealth or inheritance taxes); indirect taxes on consumption (VAT, GST, etc.); excise taxes (alcohol, tobacco and selected taxes); property taxes (land, housing, cars, boats, etc.); and trade taxes (import or export duties).

While these taxes have varied functions, their general purpose tends to be the primary fiscal or collection of revenue even as some may have regulatory or behavior adjustment objectives. Ultimately, these taxes will have allocative effect in terms of labor supply (especially with regard to the distribution of paid and unpaid work as it relates to women). Taxes have been imposed primarily on formal market sector and activities but the increase in the growth of the informal sector has led governments to seek to include that sector and activities under tax collection mandates. Since in many countries women tend to dominate in the informal sector, this approach has tremendous gender equity dimensions.

***Gender biases may also be explicit  
or implicit in tax code and applications***

Explicit biases are more prevalent in the personal tax system which developed around assessments of filing based on a person's status as single (individual) or married (joint).

Examples of **explicit biases** include specific provisions in tax regulations or tax codes that treat women and men differently (Stotsky, 1997; Joshi, 2017 and Lahey, 2018). It is argued that explicit differentiation is to be found more with regard to personal income taxes than elsewhere. The typical example here is joint filing by married couples where the woman's income is taxed at a higher marginal rate (Capraro, 2014). This is increasingly being phased out in many national income tax systems as with widespread recognition that such explicit discrimination tends to be unfavorable to women, relative to men. As argued in the above section, these discriminatory

biases tend to affect women's decision whether to work and how much to work, personal consumption and tax liability and ultimately women's and their households' wellbeing and welfare.

**Implicit biases** in tax systems are often to be found in provisions that seemingly do not discriminate between men and women but have unequal impact. For example, taxes on goods purchased mostly by women for domestic work (e.g. paraffin for cooking) (Joshi, 2017), or taxes on goods such as cigarette or alcohol purchased more by men. Such regulations or provisions are linked to social arrangements and economic behavior that have different implications for men and women. These policies have multiple aspects of value judgements, prevailing social mores and cultural aspects and may be operational at different points in time within the same society.

### *Gender biases with regard to the type of taxes*

**Direct taxes:** Direct taxes refer to taxes paid directly to the government by taxpayers. These include personal income taxes, wealth taxes, estate or inheritance taxes, gift tax, etc.

**Personal income taxes (PIT)** include multiple dimensions such as filing status—individual, joint, head of households; exemptions; deductions; etc. Individual filing status is held to be more gender equitable than joint filing as with joint filing the lower income is taxed at a higher marginal tax rate. Due to gender bias in education and the labor market in some economies women tend to fall in the lower-income category relative to men. On the whole, direct taxes, especially within a progressive tax structure, are more favorable for women as a group relative to men. Gender negatives in direct taxes can stem from the nature of exemptions and who benefits more from these. Generally, such exemptions may favor men given their ability to use exemptions as business owners, shareholders and homeowners.

Direct taxes, however, can be subject to issues of tax evasion and high administrative costs. Direct taxes can be a hedge against inflation and can be used to promote more equality and be better allocative effective, if utilized in a pro-poor and pro-gender-friendly manner. There are also gender-related challenges about how to allocate income from jointly-owned assets and how to allocate income from joint household activities such as child care. And, as noted above, joint personal income taxes are less gender equitable, though this is less of a challenge in many developing countries, given the low rate of women's labor force participation in the formal economy. Nevertheless, it does exist (Grown and Valodia, 2010). Direct taxes can also be source of explicit biases such as when exemptions apply to men but not women; or because of underlying gender status which classifies men as head of household and women as dependents. Or, in the case where women's (the wives') income is treated as secondary and hence taxed at a higher marginal tax rate. As earlier noted, these policies may discourage women from labor activity. Thus, women will tend to perform more unpaid work.

**Corporate income taxes (CIT):** Current trends toward lower corporate tax rates (part of the "taxing for economic growth" approach) have led to divergence between PIT and CIT to the disadvantage of poor taxpayers as more high income taxpayers can incorporate personal sources of income (Lahey, 2018). Other issues include the treatment of exemptions and deductions in the form of tax incentives and/or tax holidays. Transnational corporations (TNCs) can shift profit to generate low or zero corporate income; they also benefit from tax holidays and special tax regimes. These policies tend to be disadvantageous to women at the group level and tend to favor men on the whole since men are more likely to be owners and shareholders of incorporated enterprises (Lahey, 2018). Women's businesses are more likely to be small-scale and unincorporated and so do not benefit from CIT rates and capital gains exemptions. In fact, it may be the case that women's unincorporated businesses are taxed more at the rate of PIT and social security tax systems. Another important impact of corporate tax policies is the loss of revenue due to tax cuts, which severely impacts a government's



fiscal space for providing public services. Hence women, low-wage earners or others living in poverty suffer disproportionately from consequential fiscal austerity programmes which include reformed VATs and simplified business tax regimes that effectively raise new revenues from micro, small and medium enterprises (MSMEs) and the informal economy. This is now a trend in many developing countries and nowadays, many developing countries source twice as much of their revenue from VAT than they do from corporate income taxes (Lahey, 2018).

**Tax allowances for small entrepreneurs:** Women tend to purchase more goods that contribute to health, education and nutrition (relative to men) so women often bear much of the burden of VAT. This is notably so, if there are no exemptions (from VAT, for example, for education expenses, public road and rail transport fees), reduced rate or zero-rating.<sup>9</sup> In order to promote more equity with VAT, tax authorities should take measures to reduce the burden of VAT on women's small business including compensating subsistence, informal and small business owners for VAT paid to their suppliers (Lahey, 2018) as well as an increase of tax on luxury goods that support high- income lifestyles.

**Excise taxes:** These taxes tend to have more implicit biases than broad-based consumption taxes. For example, taxes on alcohol, tobacco, depending on consumption preferences, may tilt unfavorably against men as more predominant consumers of such products. But ultimately such taxes also impact household budgets and may have adverse impacts on women and girls. Additionally, preferential treatment of particular consumers or producers of a specific good or service, such as non-profits that serve the poor and which may be predominately female-headed households (or more oriented towards women with children) may be seen as biased against men's interests.

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<sup>9</sup> Exemptions are similar to zero-rated—taxes are not charged on outputs, but different from zero rating in that tax paid on inputs cannot be reclaimed by the provider of VAT-exempt goods and services. The effective rate on exempted goods is between zero and the general VAT rate due to taxes on the inputs that went into the manufacturing of the good.

**Customs duties:** These taxes on cross border flows of goods and services strongly influence patterns of development; their nature and implementation can determine which industries or sectors are favored, and who dominates that sector (Capraro, 2014 and Stotsky, 1997). For example, duties can discriminate against low-tech goods and may hence be biased against women who dominate that sector.

### *Gender biases with respect to indirect taxes*

Though all forms of direct taxes have some gender inequity dimensions, unless otherwise reformed, nowhere are the negative impacts of taxes on women as dramatically adverse and iniquitous as with indirect taxes (IDT).

The literature suggests that a wide variety of taxes, tax codes, tax regulations results in indirect taxes (which substitute for broad sales taxes and/or import duties<sup>10</sup>) that impact the purchase and the production of goods and which may have implicit gender biases (hence they are not gender neutral). These include:

Broad-based consumption taxes such as VAT which depending on the choice of goods covered, impact the different consumption patterns of men and women. As noted previously, women tend to purchase more goods that are for health, education and nutrition (relative to men) so bear much of the burden of VAT, if there are no exemptions, reduced rates or zero-rating.

As a result of the above realities, numerous case studies make very strong criticisms of VAT on the basis of gender. Generally, it is argued that VAT imposes undue burden on the poor, the majority of whom are women. Thus, VAT often is viewed as a regressive tax that unfairly targets women. For example, in Uganda, an imposed VAT on sanitary pads was reported to result in girls not being able to afford these

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<sup>10</sup> Researchers such as Joshi argue that in order to fully assess the impact of VAT on the gender distribution of welfare, it is important to understand the distributional effects of the taxes that the VAT replaced (Joshi, 2017, p. 4).

items (Makinana, 2016 and Parliament Reporter/Parliament Watch, 2017). Therefore the VAT effectively assumed the form of a penalty that was reported to be associated with a high drop out of girls. This was a public policy dilemma for the country and the consequential public outcry against the VAT led to the government withdrawing its imposed 18% VAT on sanitary pads. Furthermore, there are many other products whose pricing is discriminatory or differentiated for different consumers according to gender (Insurance, for example, is generally cheaper for women, and some children's goods have different pricing depending on who the targeted consumer is; in terms of sex and color of certain items (boy, blue and cheaper; girl, pink and more expensive—the so-called pink tax that women end up paying).) These are the specific kinds of differential impacts that tax administrators should scrutinize when reviewing their tax codes. But a more nuanced approach must be taken in assessing the gender discriminatory nature of indirect taxes. Grown and Valodia's (2010) gender and taxation country studies show that in four countries the incidence of indirect taxes (IDT) was highest on male-headed households.<sup>11</sup> Additionally, it is important to try to account for the overall net effect of IDT (in terms of its contribution to total government revenue and total spending) on women and men. IDT that contribute to spending on services that may disproportionately benefit women have to be considered in making judgements about IDT in a particular country.

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<sup>11</sup> As noted by Joshi, due to lack of income data, many researchers utilize women-headed or women-denominated households, etc. as proxies for gender when studying the incidence of VAT. Grown and Valodia also showed that overall tax incidence can fall more heavily on the richest and middle-income quintiles (women are disproportionately located in households in the lowest quintile). This result was obtained only in countries where VAT was “well designed, and some basic consumption goods were subject to reduced or zero rates” (Joshi, 2017, p. 4). India was an outlier here; the lowest quintile had the highest overall tax incidence (Grown and Valodia, 2010 cited in Joshi, 2017). It should be noted that when analyzed by type of good, taxes on utilities tend to fall disproportionately on female majority houses. This result is hypothesized to be due to the fact that women spend more on utilities to save time from household tasks such as collecting water (Ibid.).

### ***III.2 Taxing the informal economy: local government taxes, market taxes and gender***

As noted previously, governments in developing countries are increasingly finding ways to tax the informal business sector activities—including subsistence agriculture, unregistered cash or barter business or employment activities (Lahey, 2018). Women are the majority of the actors in this sector; they comprise 50-80% of such actors, so much of this tax policy impact will be borne by them. Lahey (2018) identified three basic methods of taxing informal business: negotiated fixed tax regimes that target micro businesses such as florists, beauty and hairdressing services (see Latvia); simplified turnover taxes which attached a fixed rate on gross business receipts for small and medium enterprises (SMEs) (see Cameroon, Malawi and Kenya); and flat or scaled presumptive taxes on entities such as transport operators. While, as noted by Capraro (2014) and Lahey (2018), the gender effects of these types of taxes are not yet well documented, “they risk over taxing those operating at the margins of profitability” (Lahey, 2018, p. 39). This is because, in addition to the fact that taxes on the inputs on goods (food, beverage and textiles) normally traded by SMEs tend to have higher taxes imposed upon them than those in male dominated sectors, the taxes in the informal sector may also over estimate gross receipts from the sales of goods. Additionally, negotiated tax frameworks can involve intimidation and sexual harassment of women business owners. This has been infamously the case with regard to customs taxes in Africa and elsewhere (Capraro, 2014; Lahey, 2018 and Joshi, 2017).

In some developing countries, so-called “market taxes” are fees levied on market activities. These may include roadblocks for entry on market days and other kinds of market-impeding measures such as charging for hawkers’ licenses being applied to informal and small business sectors. These fees are identified as disproportionately targeting women, when most market trades are carried out by women. These forms of local taxation are more likely to occur in low income countries in Africa where local governments do not have many varied sources of income (Joshi, 2017 and Capraro,

2014). Presumptive taxes imposed on the informal economy may differ by sectors (hairdressers, taxi services, etc.) and can have different effective tax rates (Joshi, 2017 and Capraro, 2014). Actual tax enforcement may differ according to the gender of the taxpayer especially at the local government level.

#### **IV. LINKING NATIONAL TAX STRUCTURE AND PUBLIC POLICY ON GENDER JUSTICE - SELECTED CASE STUDIES FROM THE SOUTH AND NORTH**

In general, both developed and developing countries have been reforming tax codes and tax laws to eliminate explicit biases and to mitigate implicit biases in their tax systems. Approaches to reform may vary, but generally tend to include reform of tax laws and policies to eliminate gender bias and to improve the role of women in tax administration itself. Tax policy reforms may include shifting from joint to individual taxation system, attempts toward tax gender neutrality and the integration of issues such as gender-sensitive revenue incidence analysis, research to increase knowledge about the link between gender equality and revenue raising or tax policies. An emerging area of controversy occurring across all countries is the advocacy from civil society, women's rights activities and tax officials to eliminate the so called "pink tax" (VAT levied on products primarily consumed by women and girls such as on sanitary towels, tampons, etc.). Additionally, reform of tax administration regimes may include a focused capacity building as well as the inclusion of more women as decision-makers and front line managers.

##### ***IV.1 Developed country efforts to reform tax systems to eliminate explicit gender biases***

Since the 1980s there has been a trend in developed countries toward gender neutrality in the tax system. As mentioned earlier, the 1984/85 EC report argued that tax systems impact the female labour force participation and that higher marginal tax rate was a disincentive for women to work, leading the United Kingdom (UK), France, and the Netherlands to reform their tax systems to eliminate explicit gender

disparity/discrimination. As recently as January 2019, the European Parliament (EP) encouraged individual taxation to fight gender bias in the context of fiscal justice for women. A non-legislative report adopted by the EP points out the negative impact that joint taxation has on women and argued that “tax systems should no longer be based on the assumption that households pool and share their funds equally.”<sup>12</sup> The Members of the European Parliament urged all member states “to introduce more progressively individual taxation systems, while ensuring that all financial and other benefits linked to parenthood in current joint taxation systems are fully preserved” (Garcia Valdivia, 2019 and European Parliament, 2019a/b). Elsewhere, for example, in the US, there are calls for integrating a secondary earner deduction in the tax system in order to reduce the (implicit) gender bias in the US tax code and to promote a “small, realizable step towards neutrality,” (Pignataro, 2015).

Gender and human rights activists have become increasingly active at many levels of local and national governments in fighting for a zero tax rate on feminine sanitary hygiene products (e.g. tampons and sanitary napkins) which are basic necessities vital for women’s health. Taxes on these products clearly apply only to women as a group. Many developed countries are also re-thinking, proposing or making actual changes to reduce or eliminate this so-called “pink tax”.<sup>13</sup> For example, Australia, Canada, some states in the US<sup>14</sup> and many

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<sup>12</sup> The European Parliament non-legislative report on gender equality and taxation policies in the EU, January 15, 2019 (2018/2095(INI)). Available from <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P8-TA-2019-0014&format=XML&language=EN>. According to Wikipedia, a non-binding resolution is a written motion adopted by a deliberative body that cannot progress into a law. The substance of the resolution can be anything that can normally be proposed as a motion. The Free dictionary further clarifies that this type of resolution is often used to express approval or disapproval of something that cannot otherwise be voted on due to the matter being handled by another jurisdiction etc.

<sup>13</sup> This draws heavily from the CIVIO: Medicamentalia report by Alvarez Del Vayo and Belmonte (2018).

<sup>14</sup> Connecticut, Florida, Maryland, Massachusetts, Pennsylvania, Minnesota, New Jersey, Illinois and New York also provide free sanitary products in public school bathrooms.

European States have reduced or eliminated this so-called “Tampon Tax”. As of 2007, under European law, there has been latitude for the reduction of the “Tampon Tax”. Currently, as noted by Alvarez Del Vayo and Belmonte (2018), about half of European countries, including Denmark, Hungary and Switzerland, levy the same VAT on sanitary towels and tampons as on tobacco, beer and wine.<sup>15</sup> While Ireland exempts such feminine hygiene products from taxation,<sup>16</sup> other countries such as France and Spain have traditionally offered only reduced VAT on such products. Spain has recently announced its intention to reduce the VAT on feminine hygiene products from the current rate of 10% to 4% starting in 2019 (Alvarez Del Vayo and Belmonte, 2018).

#### ***IV.2 Developing countries’ reforms of the tax system to eliminate explicit gender biases***

Most developing countries’ tax regimes also attributed income earned by married women to their husbands and their tax codes were designed to levy any non-schedular income taxes in the

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<sup>15</sup> The rate on feminine hygiene products, a product of basic necessity related to women’s health and applies only to women as a social group, which is generally the same as the rate on jewelry, wine, beer and cigarettes, averages about 20% (with Hungary 27%, Croatia, Switzerland and Denmark at 25%. These rates are higher than the tax levied on hotels in the same countries (Alvarez Del Vayo and Belmonte, 2018).

<sup>16</sup> It should be noted that European countries are restricted in their tax reduction option due to the operation of a EU directive that only allows a VAT reduction to a minimum of 5% on sanitary products. Ireland was able to offer 0% (exempt) because its rate was applied before the implementation of the European wide legislation for the reduction and exemption of VAT so it does not have to apply the 5% minimum. (Likewise, the Canary Island has tax free sanitary products because it is allowed to have a different system of indirect taxation from the Spanish mainland and the rest of Europe.) The UK Parliament sought to also undertake the 0% exemption but was not able to do so due to the directive; hence, the Parliament developed a creative outcome around this: it decided to allocate part of the tax collected from the “Tampon Tax” to women’s support groups. Along a similar vein, Scotland provides free sanitary towels and tampons to all female students at schools, colleges and universities as part of its programme to fight poverty.

husband's name and other tax regulations continue to reinforce a variety of gender biases. Quite a few developing countries (and a growing number of others) now have explicit provisions in the tax code that separate women's income from that of men's.

However, research undertaken in developing countries shows that in many countries where there are zero-rate taxes and exemptions on basic consumption goods such as food, the burden on women is not as great as would have been expected (Grown and Valodia, 2010). Many developing countries are also increasingly coming to recognize that VAT taxes on sanitary pads have implications for the accessibility of sanitary towels hence improving hygiene for women and girls.<sup>17</sup> African countries have been quite involved in addressing this issue of "Tampon tax". A growing list of parliaments and tax authorities in these and other developing countries are taking action to reduce or eliminate so-called "pink" taxes, most especially tampon or sanitary pads taxes as part of their poverty eradication programmes and human rights approach. Developing countries that have eliminated tampon taxes include Kenya (one of the first globally in 2004; Kenya also ended import duty on sanitary pads in 2011<sup>18</sup>), India, Malaysia,

<sup>17</sup> It must be highlighted that research shows that women and girls suffer from reproductive infections potentially caused by poor menstrual hygiene management. Menstrual hygiene "is a crucial aspect of achieving improved child health, education retention and gender equality" in many developing countries such as Tanzania and Uganda. Thus, Suzan Yumbe, director of Afya Plus, an NGO in Tanzania, remarked that after the removal of the tax by the Minister of Finance and Planning Philip Mpango, "it is the Government's expectation that producers and sellers of the female towels will avail them cheaply after the removal of the tax." She further noted that "there are no more obstacles to women and girls getting safe menstruation." Likewise, the Executive Director of the Education Centre for Advancement of Women said that the government's action will go a long way in improving girls' hygienic conditions as well as maintaining them in schools. Friday Simbaya, "Govt Hailed for Scrapping VAT on sanitary pads," IPPmedia.com, July 5, 2018. Available from <https://www.ippmedia.com/en/news/govt-hailed-scrapping-vat-sanitary-pads>.

<sup>18</sup> Despite these actions, activists argue that "due to high level of poverty and average households living on \$2 a day, 65% of women and girls in Kenya are still unable to afford sanitary pads." Research by Dr. Phillips-Howard found disturbingly that "1:10 15-year old girls were having sex to get money to pay for sanitary ware" (Guardian, 2017). See also: Phillips-Howard et al. (2015).



Mauritania, Uganda, Tanzania, Nicaragua and Trinidad and Tobago. In South Africa, where sanitary products are taxed value added the same as other goods classified as luxury and/or non-essential goods, in 2016, University of Witwatersrand (Wits) students called for an end to the tampon tax.

### ***IV.3 Snapshots of developing country approaches to taxation and gender***

**Argentina:** This country is currently undertaking modernization and reform of its tax system. On 1 January 2018 a key dimension of those reforms came into force after the Congress passed a package of Executive Branch proposals at the end of the previous year. However, a preliminary and very tentative review does not indicate inclusion of significant gender sensitive or gender responsive changes. In the past, researchers argued that the tax system had implicit biases in the treatment of assets, in particular with regard to exemption for interest or dividend payment on stocks and equities, assets that men are likely to own more than women (UNDP, 2010.) However, under the new reform, there are several employment and business activities which are assessable separately and individually (IMF, 2017)<sup>19</sup>. In addition, in its article IV review of Argentina, undertaken since the tax reform, the IMF called for elimination of the tax wedge for second earners in order to remove “obstacles to women’s participation in the formal labour market” (IMF, 2017). The report notes that Argentina has very low female labor force participation in the region and that 39% of women in the labor force are in the informal sectors. (The overall gender wage gap in Argentina is 24%.<sup>20</sup>) Additional indicators of non-

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<sup>19</sup> Employees without a spouse earning less than ARS \$5,783 (USD \$376) per month pay no taxes, nor do married couples who are earning less than ARS \$7,998 (USD \$520) per month. See <https://www.cloudpay.net/resources/understanding-payroll-in-the-argentina-what-global-companies-need-to-know-about-argentina-payroll>.

<sup>20</sup> This is based on broad parameters such as working conditions and job characteristics but when age, education, sector, location and occupation is taken account of, the gender wage gap is lower, about 14%. It is, however, higher (27.5%) in the informal sector. (Kolovich et al., 2017 cited in IMF, 2017, p. 26)

gender sensitivity include that income deriving from joint property is to be considered in the husband's tax filing and it would appear that there is no tax exemption allowed for the self-employed with low income, the majority of whom are women. Thus, there remains scope for significant "pro-equity reforms in Personal Income Taxation in Argentina."

The Fund applied its new Dynamic Stochastic General Equilibrium (*DSGE*) model to determine the gendered impact of a proposed reform (a reduction in the labor tax wedge) and concluded that such a reform would increase GDP by increasing female labor force participation and a decrease in gender wage gap (IMF, 2018, Box 6; Kolovich et.al., 2017 and Bretton Woods, 2019).<sup>21</sup> Overall, the Fund supports individual filing in order to eliminate explicit discrimination against women (especially with regard to the treatment of common property within marriage) (IMF, 2018 and Bretton Woods, 2019).

**Brazil** and **Ecuador** have no explicit gender differentiation, but there are four options for property in the context of taxation in Brazil: 1) total assets communicated at 50/50; and partially communicated; 2) before and after marriage acquisition; 3) total separation; and 4) hybrid that provides incentives for persons living with disabilities, age and children. This is not gendered. For Ecuador, there is no difference between men and women, rather deduction is for children and education and there is joint assessment of marriage and community property. Couples have the option of choosing their specific regime. There are also exemptions for age and disability.

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<sup>21</sup> Results from the simulations showed that (i) GDP would increase 1.2 percent following the reform; (ii) women in the formal sector, who in the model face costs associated with working (for example owing to the need to care for children), would respond more than men, as the benefits from higher after-tax income increasingly outweigh the costs from working, increasing their average hours worked by 11.6 percent; and (iii) inequality (as measured by the Gini coefficient) would not be aggravated by the reform. (IMF, 2018, p. 24)

**Ghana:** The tax code is presented as gender neutral. There is a PAYE (pay-as-you-earn system) and as many women only earn income, they may end up with higher direct taxes than men who may have non-taxed or under-taxed sources—such as tenancy business or white-collar self-employment. GTZ has reported that in 2007, the share of PIT in total tax revenue was 13%, but IDT share was 43%. Hence there is the need to improve the collection of direct taxes and extending the tax net (GTZ, 2015). Implicit biases in the tax codes are in the treatment of assets. There is exemption for interest or dividend payment on stocks and equities, assets that men are likely to own more than women (UNDP, 2010).

**India:** The country had tax codes that prioritized in favor of women: the tax threshold used to be higher for women and the Basic Exemption Limit was higher for women as well. This seemed to provide “incentive to compensate for care which can be met by low-income women”. At the same time, it must be noted that since only about 1% of working age women earned income above the tax threshold, there may not be much positive impact on women’s lives. Recently, however, due to reported abuse of the system (men shifting income to wives), the government has started to provide direct benefits to women instead of lower tax rates. India is currently at the start of a process of reviewing its existing (1961) Income-tax Act. A Task Force has been commissioned to explore what are the dimensions of “a new direct tax law in consonance with economic needs of the country” (Government of India, 2017). It is not clear whether gender issues will eventually be part of the discussion.

**Malaysia:** The country reformed its tax system in 1991. Today, there is no more attribution of income to the husband, unless the wife specifies otherwise. Now husband and wife are separate taxable units with the wife’s income still reported on the husband’s tax return. Joint filing remains possible.

**Morocco:** The country’s tax system allocated allowances for children to men. Women can claim the allowances only if they can prove that their husband and children are financially dependent on them.

**Pakistan:** The country's 2001 tax ordinance discriminated in favor of women by allowing basic exemption threshold that was higher for working women than working men. But with the 2010 reform of the tax code this is no longer the case. Men and women salaried taxpayers are treated the same and there are no special deductions or exemptions for women. Married couple taxes are also individualized.

**Singapore:** There is explicit gender differentiation in the form of child relief. Married women are entitled to additional allowance for children if they elect to be charged tax in their own names and have passed at least three general certificate examinations (GCEs) or have a higher education certificate. In the case of VAT, Singapore also provides special subsidies and allowances to cushion price and tax effects of these VAT (Lahey, 2018).

**South Africa:** Pre 1995 — the country used different tax rates and single and married women had higher tax rates. However, there has been a unified rate since 1995. But research notes that the tax collection mechanisms have implicit bias: employers automatically deduct taxes and adjustments are made after the employee files his or her annual returns. Women work less regularly (seasonal and part time jobs) but deductions are annualized for calculation so deductions are based on higher marginal tax trade. Many do not file end of year returns (not legally required) due to lack of capacity on the part of employer or individual. So, women end up overpaying taxes.

**Uganda:** The country has a very high VAT rate (18%) but with long lists of zero rated items in agriculture, education, food and long lists of exemptions including livestock, food stock, contraception, social welfare services, education, dental and medical items (Lahey, 2018).

## **V. OVERALL THE APPROACH IS TO TAX FOR GENDER EQUALITY**

The approach of en-gendering tax systems is not a radically new idea. It springs from the link made between taxation and substantive gender equality explicitly made in the gender equality conventions and normative instruments that most governments have affirmed. These include the Convention on the Elimination of Discrimination Against Women (CEDAW) and its various optional protocols and the Beijing Platform for Action. CEDAW obligates governments to eliminate prejudices and practices that express the “idea of inferiority... or stereotyped roles for men and women” and to promote economic rights (Lahey, 2018). The Platform for Action (which was reaffirmed in 2015 Beijing Plus 20 review<sup>22</sup>) is explicit about governments’ responsibility to adhere to economic rights which includes tax laws, tax benefits, spending laws and social protection programmes, all other fiscal laws and policies and entire budgets.<sup>23</sup> Furthermore, the platform also calls for fiscal policies to be analyzed from the perspectives of women, poverty, inequality and well-being and enjoins governments on the responsibility to take proactive ameliorative actions to “adjust them ... to promote more equitable distribution of productive assets, wealth, opportunities, income and services”. Furthermore, tax systems have inherited commitment to equity and efficiency, ability to pay and adequacy of revenues (Lahey, 2018).

There are cases where the tax provisions are designed to accommodate socially desirable arrangements or encourage desirable social behaviour. Positive discrimination in tax systems may be beneficial to young women. Examples include:

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<sup>22</sup> Please see UN Economic and Social Council, Review and appraisal of the implementation of the Beijing Declaration and Platform for Action and the outcomes of the twenty-third special session of the General Assembly - Report of the Secretary-General, Commission on the Status of Women, Fifty-ninth session, March 9-20, 2015, (E/CN.6/2015/3), p. 65, para. 247.

<sup>23</sup> Please see Platform for Action paras. 58(a)-(d), 150, 155, 165(f), (i), (p), 179 (f), 205 (c) and 245-349.

- Life expectancy differences between men and women - here, there may be differential treatment of pensions and annuities that take into account men's presumed shorter life expectancy relative to women's;
- On the issue of real property donation, the US tax code discounts the value over the lifetime of the taxpayer who is making the charitable donation but will continue to use the property over her or his lifetime, allowing men to discount at 20 years' horizon while women may do so at 25 years;
- Income from Pensions and Annuities: Given men's shorter life expectancy, they can receive a larger proportion of total value;
- Men and women may also have different social security rates: there may be different benefits for similar contributions.

CEDAW allows for different treatment when treatment is aimed at overcoming discrimination. Hence the taxation system should (1) treat women as equal/autonomous; and (2) seek to transform gender roles in society. As recommended by UN Women (2016 and Lahey, 2018), in this context government and tax authorities should consider taxing for gender equality either as part of tax reform or a structural de-taxation programme (that lowers all tax rates).

In conformity with ongoing initiatives already at play in many developing countries, crucial recommendations from the literature include (see Lahey, 2018 and European Parliament, 2019a/b):

- Complete exemption from PIT and social security taxes contribution for men and women living near the poverty line;
- Replace existing simplified flat PIT rate structure with truly graduated tax rate structure;
- Individualize PIT and social security taxes so as to allow for the recognition of women's contribution;

- Independent property rights in their own personal tax and social contribution;
- Ending of tax incentives and replacement with direct fiscal spending;
- Assorted policy proposals to reduce the negative gender impact of VAT and other consumption taxes:
  - Repeal VAT and other consumption taxes on gender-specific items, or implement zero-rate on items critical for care costs;
  - Low single digit rates that are gradually raised overtime and linked to service delivery of social protection payments;
  - Low-income exemptions;
  - Exempt small businesses or support with cash allowances for the cost of the VAT; and
  - Repeal user fees for core public services or for privatized services—health care, education, transportation, energy and water.

## **VI. GENDER AND TAX COOPERATION: THE WAY FORWARD**

*“The race to the bottom on corporate tax robs governments not just of revenue, but also one of the crucial policy levers to reduce inequality and promote distributions of income and wealth that are fairer and more conducive to sustained economic growth. Such measures also have a gender dimension, as women are overrepresented in small and medium-sized business, at the lowest wage levels, and in the informal sector. The more regressive the tax system, the more the burden of sustaining public expenditure will fall on the shoulders of low-income earners who are predominantly women.” - ICRICT (2019, p.8)*

The recommendations from the literature on gender and national tax policies as well as other more granular recommendations discussed in country case studies are being pushed by gender

advocates working on issues of tax reform. There is also a momentum to pursue this issue and similar type recommendations at the level of international tax cooperation and collaboration.

International tax cooperation was a prominent call in the Addis Ababa Action Agenda<sup>24</sup> (AAAA) which recommended that such cooperation be scaled up and be universal, while at the same time taking into account the different needs of the countries. Given the AAAA's recognition of the importance of gender equality issues,<sup>25</sup> it could be assumed that this ideal would also carry over into discussions of the reform of international tax policy environment and its regulatory tools and mechanisms. Yet gender issues are patently absent from discussions of international tax reform.

Traditional international cooperation with regard to tax matters have mainly focused on bilateral treaties with the emphasis on avoiding double taxation of entities.<sup>26</sup> But today, international cooperation is more multifaceted including the setting of tax norms that attempt to close loopholes and limit the ability of multinational corporations (MNCs) to avoid paying taxes (IATF, 2018). Indeed, in lieu of a global inclusive approach under the auspices of the UN, the OECD has been pursuing discussions and consultations on tax cooperation issues with both OECD members and non-members through its Global Forum on Transparency and Exchange of Information. The OECD/ Group of Twenty (G20) are also pursuing international tax reform issues with its 15 actions

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<sup>24</sup> The outcome document of the Third International Conference on Financing for Development, Addis Ababa, July 2015. At this meeting, the developed countries blocked a proposal to create an inter-governmental tax body in the UN to replace (upgrade) the current UN Committee of Tax Experts.

<sup>25</sup> See in particular paragraphs 1, 4, 6, 21, 37 and 41.

<sup>26</sup> According to the EU Parliament report, "double taxation treaties between Member States and developing countries do not usually promote source taxation, therefore benefiting multinational corporations at the expense of mobilisation of domestic resources by developing countries; notes that the lack of domestic resource mobilisation prevents fully financed public services such as healthcare or education in these countries, which disproportionately impacts women and girls" (para. 25, EU Parliament (non legislative) resolution adopted 15 January 2019).



component—Base Erosion and Profit Shifting (BEPS) projects.<sup>27</sup> As of July 2018, a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the Multilateral Instrument, MLI) entered into force with over 87 jurisdictions and signatories from both developed and developing countries. The MLI will “transpose results from the OECD/G20 BEPS project into bilateral tax treaties worldwide...and is aimed at updating international tax rules and lessening the opportunity for tax avoidance by multinational enterprises.”

At the same time, the UN Tax Committee of Experts on International Cooperation in Tax Matters, under the UN Economic and Social Council (ECOSOC), which has been in existence in one form or another since 1967 and has the mandate to review and oversee the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, would seem to have been by-passed in this round of reforming global taxation. Though some committee members are linked to the BEPS project process, the committee which is also “responsible for making recommendations on capacity building and the provision of technical

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<sup>27</sup> BEPS involved the active participation of the 34 OECD members, 8 non-members (Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia, and South Africa) and 2 acceding members (Colombia and Latvia (now a member since 2016)); it is now affirmed by at least 90 countries. Its 15 actions are: Addressing the tax challenges of the digital economy (action 1); Neutralizing the effects of hybrid mismatch arrangements (issue of double non taxation and double taxation and “pass through” entities) (action 2); Designing of effective controlled foreign company rules (action 3); Limiting base erosion via interest deductions and other financial payments (action 4); Countering harmful tax practices more effectively, considering transparency and substance (action 5); Preventing the granting of treaty benefits in inappropriate circumstances (action 6); Preventing the artificial avoidance of permanent establishment status (action 7); Transfer pricing—intangibles, risks and capital, high-risk transactions (covering actions 8, 9, and 10); Measuring and monitoring BEPs—data analysis (action 11); Mandatory disclosure rules—disclosing aggressive tax planning (action 12); transfer pricing documentation and country-by-country reporting (action 13); Making dispute resolution mechanisms more effective (action 14); and Developing a multilateral instrument to modify bilateral tax treaties (as opposed to renegotiating double taxation avoidance agreements (DTAAs)) (action 15).

assistance to developing countries and countries with economies in transition” is not a significant leading player in global tax cooperation matters. There is therefore need for an intergovernmental body under the UN to oversee tax matters and tax cooperation and one that will focus on issues of equity including gender issues.

So, at multiple levels, there are discussions about tax reform and the intensification of cross-national coordination and collaboration on tax matters. It is in this context, of what Marcos Valadão has identified as “unprecedented interconnections of tax systems”, that tax justice advocates are also strongly arguing that tax cooperation should be grounded in an understanding that tax policy should take equity into account.<sup>28</sup> They argue that the ability to pay is already enshrined in many tax systems, and emphasize the need to also consider distributional and gender impacts. This is extremely relevant and needs to be reinforced in an era of increasingly harmful tax competition and practices, tax havens, intense and even more complex transfer pricing practices, rampant tax deferrals by MNCs, treaty shopping, digital economy transactions and commercial “illicit financial flows”, and their potential for syphoning off badly needed domestic resources from developing countries.

Much of the effort at international tax coordination seems to be focused around “tax transparency” and “information exchange” (see “Global Forum on Transparency and Exchange of Information for Tax Purposes”<sup>29</sup> and the “minimum standards of BEPS” (action 13)). However, this is not sufficient to address the sustainable development and gender equality challenges at play in the current international political economy.

Gender and tax justice advocates argue that in order for tax cooperation and any tax reform it generates to be beneficial for

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<sup>28</sup> Marcos Aurélio Pereira Valadão, *Developing Countries and the Contemporary International Tax System: BEPS and other issues*, South Centre Tax Cooperation Policy Brief No. 7 (Feb. 2019).

<sup>29</sup> Formerly, The Global Forum on Tax Transparency, an OECD creation, now a more multilateralized entity with the participation of developing countries.

women's empowerment and gender equality, governments should consider to what extent tax policy reinforces or breaks down gender inequalities. Tax policies should also be scrutinized as regards to their impact upon paid and unpaid work (in terms of time costs and benefits provided). For this process to be effective, entities such as the OECD, the IMF and the World Bank must, in the first instance, allow for a diversity of viewpoints including from regional platforms and developing country think tanks. These advocates are striving to integrate and drive programmes for action that address the concerns and challenges facing developing country tax authorities and administration. Secondly, developing countries must be provided the necessary policy space to reform their tax regimes and processes in a manner that supports pro-poor, gender sensitive and sustainable development measures.

Since the inception of the major reform process such as that implied with BEPS, voices from the South as well as northern think tanks have pointed out that BEPS will fail in its own internally stated objectives, if MNCs are not paying their taxes where they have economic activities and value is created (Valadão, 2019; Eurodad, 2015; ICRICT, 2019). MNCs paying their fair share of taxes is the only means by which developing countries will reap the benefits from BEPS or any similar mechanism. However, as noted in numerous critical assessments, the OECD BEPS has not abolished the so-called patent boxes<sup>30</sup> (or innovation box, US Congress) and has only promulgated “weak and unclear guidelines, with obvious loopholes for MNCs and potentially new options for profit shifting” (ICRICT, 2019). In essence, the BEPS regime may have effectively legitimized their use in the international tax system (Eurodad, 2015; Economist, 2015 and ICRICT, 2019).

The Independent Commission for the Reform of International Corporate Taxation (ICRICT), while praising the BEPS project for addressing hybrid mismatches, information exchange, tax ruling

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<sup>30</sup> The vast intangibles of MNCs are brands, copyright patents, etc. - so-called intellectual property (IP). They received tax benefits for the royalties associated with these intangibles, through the so-called “patent box” through which companies pay a lower tax rate on IP that were developed in a country (Economist, 2015).

transparency, and treaty abuse, nonetheless, argues that under or in spite of BEPS, companies can still shift profits to low-tax jurisdictions via transfer pricing; furthermore, the project failed to reach consensus on allocating the profits of multinationals and failed to address tax avoidance by digital companies,<sup>31</sup> whose conduct “gave rise to the BEPS project.” ICRICT further noted that the BEPS project didn’t sufficiently address tax avoidance via excessive related-party royalties and interest, and argues that the negative effects are the “normalization and proliferation of “acceptable incentives”, such as patent boxes. The group also faulted the BEPs dispute resolution process for its lack of transparency and maintenance of “compromised legitimacy” into the BEPS reforms. These and numerous other failings and negative impact on development and equity prompted ICRICT commissioner, Joseph Stiglitz, to argue that, “giving the OECD, rather than the UN, control of assessing the global tax structure “put the fox in charge of the hen house.”

The Commission therefore called on the governments in the Inclusive Framework on BEPS, the UN Tax Committee, and multilateral institutions to look at alternatives to transfer pricing and pursue unitary taxation for multinationals, based on a formulary apportionment underpinned by a global effective minimum tax rate for the next phase of the BEPS process. The Commission’s rationale for a formulaic approach is that it “would result in a fair and sustainable allocation of taxing rights between developing and developed countries...(and) ensure that global profits and associated taxes could then be allocated according to objective factors such as the sales, employment, resources (and even digital users) used by the company in each country, rather than where they locate their different functions (procurement, marketing, funding, etc.) and claim their Intellectual Property” (ICRICT, 2019).

The ICRICT approach and recommendation for international tax cooperation, while not focused on gender, does recognize the

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<sup>31</sup> For example, “the introduction of taxes based on turnover targeted at digital multinationals.”

impact of taxation on women. Its recommendation is a necessary starting point for making tax cooperation fair and equitable and therefore eminently available for gender responsiveness.

As can be seen from the discussion above, ultimately, there are challenges with current attempts aimed at addressing the inter-connectivity of national tax systems, particularly with the OECD BEPS approach adopted by G20. This approach leaves developing countries at a great disadvantage and hence does not provide a good ground for the practical project of enabling women's empowerment and welfare at the national level. However, the work of the UN tax body, as well as that of regional tax organizations, such as the Inter-American Center of Tax Administrations (CIAT) and African Tax Administration Forum (ATAF), and intergovernmental entities such as the South Centre's Annual Tax Forum of Developing Country Officials on Tax Policies, as well as research institutions, can contribute a great deal both to the reform of national tax systems as well as regional and international tax reform. These organizations must also work to develop and understand gender issues in the context of tax policies and tax cooperation. Developing countries should thereby be encouraged to empower their tax authorities to incorporate the gender dimensions in their tax policymaking and in their international cooperation activities.

The work of the South Centre's Tax Initiative, CIAT and ATAF as well as the Tax Justice Network can support expanding work in analyzing and advocacy for gender issues in developing countries' tax policies as well as in international cooperation. This analysis could draw on available documentation such as a growing number of research and case studies examining gender and taxation as well as intergovernmental and governmental entities' comments, observations and plans on actions on the subject matter. These should include CEDAW Committee reports as well as recent output and communications from the European Parliament.

The 2016 CEDAW Committee's concluding observations on the *Combined fourth and fifth periodic reports of Switzerland* speak

directly on the Swiss government's responsibility for the extra-territorial (or cross-border, or spill-over) impacts of tax abuse (arising from financial secrecy and tax policies) on women's rights.<sup>32</sup> On the issue of women's economic empowerment, the committee, in line with its general recommendation No. 28 on the core obligations of State parties under article 2 of the Convention, recommended that Switzerland undertake independent, participatory and periodic impact assessments of the extraterritorial effects of its financial secrecy and corporate tax policies on women's rights and substantive equality... The CEDAW committee's determination hence projected that "tax abuse presents a structural barrier to substantive equality of women" (Alliance sud et al., 2016).

The EU Parliament's non legislative resolution on gender and taxation, specifically paragraphs 26-30, addressed the impact of tax evasion and avoidance on gender equality, which it identifies as major contributors to gender inequality in the Union and globally. This is so because these practices limit the resources available to governments to increase equality at the national and international levels. The EU Parliament resolution also calls on the EU Commission and the Member States to promote gender-equal taxation reforms in all international fora, including the OECD and the UN and to support the creation of a UN intergovernmental tax body with universal membership, equal rights and equal participation of women and men. It additionally urged Member States to mandate the Commission to review existing double taxation treaties so as to examine and address these problems, and to ensure that future double taxation treaties include gender equality provisions in addition to general anti-abuse provisions.

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<sup>32</sup> According to Zucman (2011, cited in Alliance sud et al., 2016), one third of all unrecorded offshore financial wealth in the world is held in Switzerland—much of it untaxed (Alliance sud, et. al., 2016 and Swiss Banking, 2014). The Swiss government itself has recognized the adverse impact of illicit financial flows on sustainable development (Swiss Federal Council Study, October 2016).

## **VII. CONCLUSION AND RECOMMENDATIONS**

This chapter has sought to present a review of the state of thinking and research on a pressing issue of the day: tax reform and tax cooperation and its gendered impacts. There is undeniably widespread agreement amongst all the entities of global governance with responsibility for a role in macroeconomic, financial and trade policies that gender equality and women's empowerment are important to sustained growth and development. Increasingly, these same voices are articulating and researching on how fiscal policy both on the budgetary and on the revenue side can be made more efficient, gender sensitive and gender responsive. Taxation is the latest area of focused attention in this regard. There is now a quite strong body of work, including case studies, that demonstrates how the tax system can work to the disadvantage of socio-economic development and social goals including gender equality and women's empowerment.

However, these research outcomes and the rapid uptake of their findings into the policy and governance discussions are incomplete and insufficient. As noted by the EU Parliament and in other reports, there is need for more in-depth research and enhanced collection of gender-disaggregated data to promote better understanding and more specificity of the gender-differentiated distributional and allocative effects of the taxation system, both locally and internationally. There is a need for more modelling of good practices demonstrating how the tax system can deliver positive achievements that promote gender and other social equality.

Indeed, much more emphasis should be put upon exploring the human rights dimensions of the challenging aspects of tax avoidance and tax evasion including the role of government accountability and accountability of actors who violate human rights. Many questions need to be further interrogated on the path to developing and implementing fair national and global tax systems designed to meet the needs of the poorest -- women and men, boys and girls.

There are numerous questions which need to be addressed such as how a tax system can be designed to provide equal sharing of paid and unpaid work, income, pensions and other assets which requires cogent and workable provisions that can be adapted to different national circumstances (European Parliament, 2019a/b):

- The question of unpaid care and the tax system is a quite pertinent one that will require further case studies and investigation. Likewise, what incentives can the tax system provide to increase the availability, accessibility and affordability of goods and services, such as child and elder care that are critical for the human well-being?
- How can governments use the tax system to leverage low-wage earners' income-earning potential and reduce the constraints faced by women owners and other disadvantaged groups involved in the micro and small business sector (and are there good examples)?

These are all important issues that must be incorporated into future discussions of tax reform, nationally and globally.



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A substantive reform of the global tax system involving a variety of multilateral platforms is underway. The question is not whether the tax standards and practices will change, but in which direction.

Developing countries have long sought changes in rules, standards and procedures shaping the allocation of taxing rights among sovereign states. In the wake of the 2008-2010 Great Recession, developed country governments engaged in massive public sector layoffs and channelling enormous public resources to bail out large financial companies and their wealthy investors. The Panama Papers, the Paradise Papers, the Lux Leaks became household words in the United States and Europe because of the journalistic coverage. Other scandals, such as the “cum/ex” fraud in Germany involving a loophole in the taxing of dividend receipts were less known but just as materially significant. Tax reform, particularly as it applied to the treatment of corporations working in multiple tax jurisdictions, thus became not only a problem of developing countries but an issue of global concern.

In November 2016, the South Centre launched the “South Centre Tax Initiative” (SCTI), a project to build a network of tax officials and experts from the South to advance the interests of developing countries in the current global effort at tax reform and combat against illicit financial flows. This publication is an outcome of this project based on contributions from developing country officials. It is part of an effort to create international literature among the practitioners of tax policies and administrations from developing countries to share the technical content of developing country innovations within the international tax community. The book analyzes particular cases or issues in order to draw lessons from experiences on tax reform which may be useful for other developing country officials and practitioners around the world and promote tax cooperation.

