CHAPTER 10

What Tools Can States Use When Faced with Systematic Tax Avoidance?

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The time has come

The tools are there – it is only a question of starting to use them

Tax avoidance arises where national tax law meets multinational companies. National tax law is designed for national companies. For that very reason, and for a long time, national states have seemed unable to handle the issues arising from the behavior of multinational companies. Today, however, the time for excuses has come to an end. This chapter presents some of the key tools, informed by research, that can be used unilaterally by states to reduce tax avoidance to a minimum. Put simply, if states individually or collectively use the toolbox, they can handle almost all the issues in international taxation identified today.

The corporate veil

The corporate veil is a legal expression for the concept that a shareholder cannot be held accountable for what a corporation does. The shareholder

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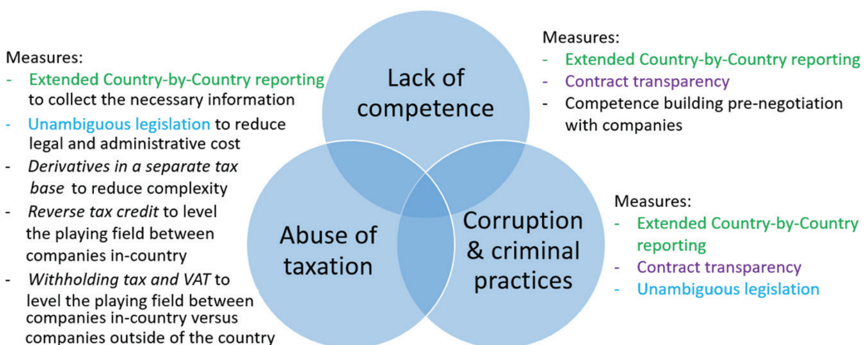
cannot see through that veil, and hence cannot be held responsible for the actions of the corporation. This has penetrated legal thinking to such a degree that the actions of subsidiaries are in most cases viewed as separate from their parent affiliation, which is taking the corporate veil into the absurd. This would compare to viewing the actions of an octopus arm as separate from the octopus itself. When Company A is shareholder in Company B, and the management of Company A has done something to, in or through Company B, it is the management of Company A and Company A itself that needs to accept the consequences of what was done to, in or through Company B.

The undertaking

My own research on the tools that states can use to unveil tax avoidance and capital flight started in 2007, was formalized in 2011 and completed in 2018. The findings suggest that more than 95% of the loss of tax base that countries experience is covered by 6 areas of tax abuse, 2 areas of criminal activity, and 1 area of lack of competence. The results are summarized graphically below.

The results

The 6+2+1 areas can be split into 3 segments with overlapping measures:



Source: Frian Aarsnes, 2018.

The 6+2+1 areas can, as I will show in my subsequent explanation of the results, be seen as the main causes of capital flight. The take home message from the reports summarizing my research is that it is actually fairly easy to fix most of the problems, *if states only use the tools they have at their disposal.* But heavy lobbying deliberately confuses the matter, by redirecting the focus of governments in the direction of mechanisms that are obviously difficult, obviously unfair or obviously demand collective actions by a large number of countries. The goal of the lobbying is equally obvious – to keep attention away from the easy fixes that work as long as lobbying does not succeed in destroying them. Somebody is bound to want to dull the tools in the toolbox for fighting the battle against capital flight.

The results explained: Lack of competence

Lack of competence is a major cause of capital flight. As an example, many of the largest natural resources are found early in the opening up and early exploration phase in a region. This is the period when countries are most vulnerable. Officials negotiating deals with the extractive industry companies often lack information and competence relating to the resources in question, in the early stages. Most of the relevant legislation is missing or is massively inadequate. The outcome is almost always that the country in question does not get its fair share, the contracts are non-renegotiable and the normal control mechanisms with respect to the right of the government to control physical production and conduct tax audits, environmental audits and human rights audits are not in place. In a negotiation, which can be compared to a fight between a heavyweight and a lightweight, industry often "wins" over government and the result is, by default, very weak contracts.

Three measures can greatly enhance countries' ability to turn the odds in their favor:

- Extended country-by-country reporting, i.e. reporting of taxes in their natural context of revenues, cost, employees and other key numbers, will give governments the necessary information about the companies they are about to engage in negotiations.

- Contract transparency will mean that governments will have insight into similar contracts which will greatly help the government avoid bad deals.
- Increasing the knowledge and the competence of the negotiation team pre-negotiation is vital, including hiring experienced external negotiators and legal and economic resources as part of the negotiation team, either directly or as back office.

The results explained: Corruption and criminal practices

Corruption and criminal practices is another major cause of capital flight. In addition to the obvious laws against these criminal activities, it is also necessary to limit the ability to engage in corruption and criminal practices. Information in the public domain is key here.

Three measures would greatly enhance the work against corruption and criminal practices, two of them overlap with measures against lack of competence and two of them overlap with measures against tax abuse:

- Extended country-by-country reporting allows insight into how revenues, costs and taxes are distributed across countries within multinational corporations, and thus provides the necessary information as to whether companies are desirable partners in opening up new extractive sectors in a country.
- Contract transparency pre-signature would make it much more difficult to corrupt members of the negotiation team, members of ministerial decision processes and key public and political figures.
- Many of the corruption and criminal practices are opportunity-driven, i.e. circumstances allow these actions to be done with little probability of being caught, often in areas where the law is unclear. Unambiguous legislation is – in addition to transparency – therefore a must in order to limit the opportunity for corruption and criminal practices. Many companies and people say that they have followed the letter of the law. This often means that they have interpreted the laws in their favor. Reducing the room for interpretation by creating

clear and unambiguous laws would greatly limit the opportunity and willingness to circumvent the legislation of a country.

There are of course many other actions that can and should be taken against corruption and criminal practices, but it is important to emphasize that the three measures suggested above will work as part of a complete system that limits the opportunity for embarking upon such practices.

The results explained: Abuse of taxation

Abuse of taxation is the third major cause of capital flight. Whether one is talking about illegal tax evasion or supposedly legal tax avoidance is mostly academic. The point is that tax laws are made with national companies in mind, while the multinational companies operate in a room where several sets of legislation meet. Hence, we have large, unregulated areas, areas which overlap and fixes that do not solve the underlying problem of a complete, fully orchestrated and optimally calibrated taxation of multinational companies on a par with national companies, so that the competition among companies is as much as possible unaffected by the taxes in any particular country.

Here too information, through extended country-by-country reporting, is a sine qua non in order to see what is going on within each multinational company. Without knowing what is going on, it is also difficult to see whether measures introduced effectively change the capital flight picture or not. This is also important in order to avoid taxation of multinational companies over and beyond taxation of national companies.

While unambiguity is a must in any law, it is absolutely critical in tax law. Without unambiguous legislation the tax field is wide open to interpretation, complicated tax cases and unequal treatment of companies.

In addition, along with transparency and unambiguous legislation, there are three measures that are very important to curb the capital flight resulting from tax abuse:

- It is absolutely critical to move derivatives and derivative elements into a separate tax base in order to reduce the complexity of taxation.

Moving derivatives into a separate tax base will allow companies to do hedging, as the economic expectation of hedging is zero or slightly positive over longer periods of time, but it will not be possible to utilize a country's tax system for speculative use of derivatives where losses are placed in a country in order to create tax deductions while revenues are placed in low- or no-tax jurisdictions.

- In order to ensure that national companies and subsidiaries of multinational companies are competitive on the same level, i.e. unaffected by any differences in taxation between countries, it is important to negate the effect multinational companies have by organizing part of their activities in low- or no-tax jurisdictions. This can be done by utilizing the same principle that is used to avoid double taxation – tax credits. By reversing the tax credit principle, the deductibility of internal cross-border cost transactions can be reduced, so that the taxation of the subsidiary of the multinational company is returned to what it would have been if it were a national company. This mechanism follows the OECD's suggestion of regulating cost deductions in the internal law of each country.
- Last but not least, it is important to make sure that companies organized so that revenues are collected in another country than where the buyer is (including digital business models), do not gain a competitive advantage in comparison with the taxation of profits of national companies and subsidiaries of multinational companies (when reverse credit is used on the subsidiary's internal cross-border cost transactions). It is therefore necessary to tax cross-border revenue transactions on a par with the taxation that companies would have had if they had a sales operation inside the country in question. Because the main taxation of the national company and the multinational subsidiary is the VAT towards end-user and profit taxes, it is important that the taxation emulates this taxation. With VAT it is easy; you only have to put VAT on the cross-border revenue transaction. The easiest way to emulate the profit taxes is to put withholding tax on the cross-border revenue transaction. These two taxes are very precise as they are only put on the actual transactions, instead of trying to tax the

> corporation. The organization of the collection of these taxes is that it is the end-user/buyer in Norway that pays both of these tax elements; if the buyer is an end-user, he or she pays both the withholding tax and the VAT, if the buyer is a company there is no VAT as that would have been deductible anyway so the payment is only the withholding tax. This can in today's digital society easily be regulated by having the bank or credit card company deduct from the account or credit card the withholding tax and the VAT when a payment goes abroad.

As almost all capital flight is connected to derivatives, cross-border cost transactions or cross-border revenue transactions, it is expected that these measures – extended country-by-country reporting, unambiguous legislation and the outlined tax measures – will capture and tax 95% or more of the capital flight. It will also ensure that today's negative spiral of tax competition between countries will effectively end, and countries will be able to reduce taxes due to a broader tax base.

How the measures work in combination

There is no single silver bullet to kill capital flight. An orchestrated and coordinated effort is needed in order to achieve any desired goals in restricting capital flight and protecting the tax base of each country.

The background for identifying the measures, or policy recommendations, is a careful weighing of existing fiscal mechanisms up against each other in order see which mechanisms will likely result in the greatest reduction in untaxed capital flight (once the capital flight is taxed, it is not capital flight anymore, but rather the equivalent of moving taxed funds cross-border between affiliated entities).

Weighing up the evidence, the analysis identified the following measures against untaxed capital flight on top:

(1) transparency,
(2) competence building,
(3) unambiguous legislation and

(4) three simple, but extremely efficient fiscal mechanisms: i. separate the taxation of derivatives from the regular tax base of businesses in order to reduce complexity; ii. utilize reverse tax credit against cost transactions across borders (into the country); and iii. utilize withholding tax and VAT against revenue transactions across borders (out of the country) in order to level the playing field between national and multinational companies.

Again, it is important to emphasize that the policy measures recommended create an orchestrated system, which should be introduced as a comprehensive package in order to avoid loopholes that can be utilized to keep the untaxed capital flights from flowing.

Transparency: Extended country-by-country reporting (ECBCR)

Extended country-by-country reporting should report key financial numbers in addition to the publishing of taxes paid country-by-country. It is fully possible to demand more, but reporting less than the key financial numbers below for all countries will result in some sort of information failure (depending on which key financial number(s) is/are not reported):

Employees should be reported in order to measure the human capital going into the operations in a country, in addition to the financial capital employed. Employees should be reported as FTE's (full time employee conversion) in order to secure parity among all countries, and that the cumulative number of employees should match the employees reported for the group in FTE's.

Investments are the financial capital employed for the operations. Together with the human capital, they represent a measure of the effort put into the country. The investments should be reported, as all key financial numbers, in the company's functional currency, so that it can be aggregated immediately across the reported countries and compared to the investments reported in the financial statements.

Production is a key number by which it is possible to greatly improve global production and origin statistics. Production should be reported for each bulk

commodity produced. By bulk commodity we understand every commodity that is sold based on volumetric standards only (tons, barrels, cubic meters, cubic feet, kilos, ounces, grams, etc.). A unified standard should be agreed upon, so that companies always report the same commodity in the same units.

Revenues and *costs* are vital in order to know the economic outcome of yearly operations. Without *both* these numbers it is difficult to assess the operations in conjunction with employees, investments and production. It is very important that all key financial numbers (investments, revenues, costs) are reported pre-elimination, i.e. as the numbers are for each country. Eliminations should be reported as a separate "country" in order to be able to arrive at the reported financial numbers when aggregating the country-by-country numbers.

Accrued taxes in the profit and loss statement and *payable taxes 1.1 and 31.12* in the balance sheet show the connection between the financial statement numbers and the *taxes paid* reported under the country-by-country reporting of taxes: payable taxes 1.1. + accrued taxes for the year – payable taxes 31.12 = taxes paid.

It is possible that companies will have to combine several accounts to arrive at accrued taxes in the profit and loss statement and likewise to arrive at payable taxes 1.1 and 31.12. The important thing is to show how financial numbers agree with paid taxes.

Transparency: Contract transparency

Contract confidentiality only benefits the companies, which have the most information to begin with. Contract transparency will transfer a lot of knowledge from companies to governments, thus ensuring that governments start negotiations with less of a disadvantage. Furthermore, it is important that each country in a negotiation with an extractive company or a large multinational company engage competent personnel, particularly when it comes to negotiating skills, legal and economic skills. Without such support, and being at an information disadvantage vis-a-vis the company, the likely outcome may be another bad deal.

Competence building

Countries with non-renewable or renewable resources need to ensure that they have the necessary skill sets to engage in broad scale petroleum or mining activities. Such activities nowadays are high-tech and capital intensive. It is very important that the country is able to match the companies with enough technical and economic resources, and in advance of developing new sectors one should seek to initiate education programs at the universities(y) of the countries(y) in question.

Unambiguous legislation

It is not only tax law that needs to be unambiguous; the same is the case with competition law, accounting law, business law, bank laws, etc. If one discovers that the country's legislative system may not be up to the task of handling extractive industries, the whole judicial framework should be reassessed.

Taxation: Derivatives in a separate tax base

Many companies have internal contracts similar to derivative contracts or which at least include derivative elements. These elements should be seen as a separate business with its own contract clauses, its own accountants and its own decision-making processes, and it is thus important to treat them distinctly from the rest of the business. This is because derivatives can be combined with any other type of transaction or other derivative to create virtually anything. Segregating them into a separate tax base ensures that the company only engages in healthy derivative activities. If not, the desire to use derivatives to "save" taxes may become irresistible.

Taxation: Reverse tax credit

The reverse tax credit method can be enacted unilaterally in a country's tax system, the same way as the tax credit method is enacted in a country's tax system, or agreed upon in a tax treaty. The reverse tax credit method does not need to be included in tax treaties, though, and does not

affect existing tax treaties as it only applies to the deductibility of costs according to the internal tax code in a country. The method also applies on globally available information, and is thus not dependent on lifting the corporate veil.

The reverse tax credit method is a method which unilaterally takes care of adjusting the effects of a cost base that is disproportionate to the revenue base in a country. The reverse tax credit method is an alternative to adjusting the revenue up to match actual sales to the market in-country. However, adjusting the revenue would be in potential conflict with tax treaties on the taxation of revenues between countries. Today tax authorities have very little information about what goes on in the various parts of multinational companies. Most of the information that tax authorities collect or are given through automatic information exchange agreements is about individual citizens, not multinational companies. The reverse tax credit method allows tax authorities to perform a theoretically correct taxation of a multinational company/subsidiary without having to speculate on what is happening in low-tax or no-tax jurisdictions. The multinational company/subsidiary is given the benefit of the average tax rate that the multinational company already has. A company that is thus more aggressive in their approach to reducing taxes, is then simultaneously and automatically reducing the tax rate applied to cross-border cost transactions and non-transactional cash flows. The reverse tax credit principle would utilize an auditor approved, globally consolidated financial statement, but in case of the lack of such, it is possible to set the tax as low as zero until the corporation provides the necessary documentation needed to secure the correct tax deduction for internal cross-border cost transactions.

Taxation: Withholding taxes and VAT

It is important that the withholding tax is set at a level which creates equal competitive conditions between national companies/subsidiaries of international companies and companies that have their entire business outside the borders of the country in question. The reason for this is that the withholding tax level is not set for purely tax purposes as is the case

for internal tax law, but rather to secure level competition between all companies. This is thus a method by which transactions cross-border are made on a par with transactions in-country. It is thus important that the withholding tax and VAT are paid by the buyer in-country, and are not deducted from the amount paid to the seller outside the country. This ensures that the withholding tax and VAT do not introduce price distortions between countries and helps promote equal competition in-country.

Calibration of taxes

It is important to calibrate the taxes in a tax system to avoid situations with taxes too high for a company when conditions are challenging for the company, or situations which produce less than intended taxes when conditions are favorable for the company.

It is of particular importance to ensure that one chooses the correct withholding tax mechanism and that it is graded to ensure equal treatment of companies depending on the taxation in the opposite country.

Just do it!

Countries need to know that mechanisms to curb capital flight and erosion of the tax base exist. The good thing is that none of these mechanisms need agreement among a large group of nations in order to be implemented. All of them can be implemented unilaterally, and if implemented by all countries, the result would be almost equal to unitary taxation, only more precise as both the reverse tax credit and the withholding tax/VAT approach to taxation of cross-border transactions are surgically correct as they *only* address the transactions that cross the national border.

References and Reading Guide

The background for identifying the problem areas of capital flight comes from nearly 30 years of experience in auditing, extractive industries, as well as international consulting.

The background for identifying the measures, or policy recommendations, is a careful weighing of existing fiscal mechanisms up against each other in order see which mechanisms would result in the greatest reduction of capital flight.

The policy recommendations and the reasoning behind these are summarized in the following reports published on the webpages of Publish What You Pay Norway (http://www.publishwhatyoupay.no/nb/publications). The interested reader will also find all the references to the relevant literature underpinning this article:

TRANSPARENCY:

- Murphy, R. (2013, November). *An extended country-by-country reporting standard. A policy proposal to the EU. Volume 2,* F. Aarsnes (Ed.), Publish What You Pay Norway.
  The report explains the full reasoning behind why country-by-country reporting of paid taxes alone is not enough. Paid taxes need to be reported together with key financial numbers – employees, investments, production, revenues, costs, accrued taxes and payable taxes 1.1 and 31.12 – that put the paid taxes into the correct context.
- Aarsnes, F. (2014, December). *Transparency agreement: A tool for multinational transactions.* Publish What You Pay Norway.
  The report gives a clear picture of the 4 main transparency mechanisms for the 3 main levels needed:
  Level 1: Industry vs. government → EITI and contract transparency
  Level 2: Company vs. investor and society → extended CBCR and contract transparency
  Level 3: Company vs. tax authority → transparency agreement

TAXATION:

- Aarsnes, F. (2011, December). *Protection from derivative abuse.* Publish What You Pay Norway.
  The report shows how important it is to split derivatives and similar transactions into a separate tax base, separate from ordinary business profits. The report discusses the separation method (simple) versus the substitution method (complex).

- Aarsnes, F. (2017, May). *Taking away the tax effect of tax havens. Cross-border taxation methods and reverse tax credit.* Publish What You Pay Norway.
  The report gives the main reasoning behind both reverse tax credit for use on cost transactions cross-border (into the country) and the use of withholding tax and VAT on revenue transactions cross-border (out of the country).
- Aarsnes, F. (2017, December). *The roller-coaster mechanism in the world economy. Mark-to-Market and transactions outside the market*. Publish What You Pay Norway.
  The report, particularly chapter 5, explains why one needs different taxation models for the following situations:
  - Fully national companies
  - Partly national companies – subsidiaries of multinational companies
  - Only employees nationally
  - No national elements
  - Special attention: derivative contracts

  The report also describes how making fair value adjustments under IFRS part of a segregated part of the equity, which cannot be used for dividends, would protect companies against future financial crises in the world economy.
- Aarsnes, F. (2013, November). *A guide to optimal resource taxation. The case for windfall taxes.* Publish What You Pay Norway.
  The report introduces the Quadrant-Cross, an instrument that can be used to analyze the efficiency and optimal calibration of taxation systems, particularly in extractive industries. However, many of the principles can also be fruitfully used in analyzing other production industries.