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POLICY DEPARTMENT  
ECONOMIC AND SCIENTIFIC POLICY **A**



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# The Role of the Financial Sector in Tax Planning

Study for the TAXE2 Special Committee





**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **The Role of the Financial Sector in Tax Planning**

**STUDY**

## **Abstract**

This document was prepared by Policy Department A at the request of the TAXE2 Special Committee of the European Parliament.

The study reviews common principles behind financial sector practices that may feature in tax avoidance or evasion. Mechanisms include the exploitation of mismatches in international taxation and financial sophistication; and the exploitation of the qualification of corporate cash flows.

The paper issues concrete recommendations with respect to international cooperation, and the completion of Banking Union.

This document was requested by the European Parliament's Special Committee on Tax Rulings (TAXE2).

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## LIST OF ABBREVIATIONS

- ATAP** Anti-Tax Avoidance Package
- ATP** Aggressive Tax Planning
- BEPS** Base Erosion and Profit Shifting
- CCA** Cost Contribution Arrangement
- CFC** Controlled Foreign Company
- EP** European Parliament
- GDP** Gross Domestic Product
- Greens/EFA** Greens/European Free Alliance
- HNW** High Net Worth individuals or households
- ICIJ** International Consortium of Investigative Journalists
- IMF** International Monetary Fund
- MNC** Multinational Corporations
- OECD** Organisation for Economic Cooperation and Development
- SPV** Special Purpose Vehicle
- UNCTAD** United Nations Conference on Trade and Development

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## EXECUTIVE SUMMARY

The symbiosis of financialisation, globalisation and digitisation is threatening the very concept of nationally organised fiscal revenue bodies. Multinational corporations (MNC) and high net worth households (HNW) together with their global financial service providers have uprooted the financial as well as the fiscal system.

The speed with which tax and legal systems in various countries adapt to – one should arguably say pursue or remedy – these complex developments, varies. This inevitably creates paths of least resistance that are efficiently identified and put to use by financial advisors on behalf of their corporate and private clients. Commercial and investment banks, insurance companies, wealth managers and other financial service providers cater to every need of MNC and HNW to channel capital flows in the most « efficient » way.

Financial institutions, and banks in particular, are well-placed to be solicited in aggressive tax planning (ATP). They have access to the significant amounts of capital implied in large-scale arrangements, in some cases for only a very limited period of time. Their network of entities across multiple jurisdictions provides a conduit for these funds. Their ability to tailor often extremely complex financial securities can respond to any conceivable tax planning demand.

Of course, the involvement of the financial sector can be as limited or passive as establishing *bona fide* bank accounts. At the other extreme, financial institutions can actively reap or join in the tax benefits themselves. For most of the ATP schemes in the *catalogue raisonné* of this study, a business or personal rationale could be envisaged wherein tax considerations do not dominate. On a very general level, the common denominator is the deliberate exploitation of loopholes created by the imperfect international consistency and coordination of tax rules or fiscal compliance reinforcement efforts.

The lack of consistency and coordination concerns several dimensions, such as issues related to the pricing of financial instruments and intangible assets, the qualification of corporate and personal income categories, and the verification of the identity of the ultimate beneficial owner of corporate entities or financial accounts. The decisive factor is that, almost by definition, *location* plays a fundamental role in international taxation.

The European Commission for example notes that 72% of profit shifting in the European Union makes use of transfer pricing and tax-effective location of intellectual property. The remaining profit-shifting schemes involve debt shifting. Close to a third of cross-border corporate investments are channeled through offshore jurisdictions. The negative spillover effects of harmful tax practices appear to be far more significant on developing countries than on developed countries.

Aggressive tax planning is not the prerogative of multinational corporations. It is estimated that about 6-8% of HNW financial wealth is held offshore, the estimates ranging from only about 1% in Japan, 7% in Europe to maybe 30% in Latin America, the Middle East and Africa. In total, offshore wealth amounts to approximately 10 trillion USD.

Economics, and the design of optimal mechanisms such as taxation, are a matter of incentives and information. Fiscal authorities must gain a clear understanding of the demand and supply drivers for aggressive tax planning schemes and the unintended incentives that tax legislation provides to designers and operators of such schemes. As is clear from the schemes discussed herein and those covered in the literature, MNC and HNW aggressive tax planning schemes are only viable where the jurisdictions concerned suffer from inconsistency of definitions and consequently tax treatment, and from a lack of coordinated information exchange that impairs a comprehensive understanding of the

workings of international aggressive tax planning schemes. Country-by-country reporting cannot substitute for an integral understanding of the full scheme. “Productivity” or “return on investment” calculations involving isolated entities’ assets, equity or workforce at best paint a partial picture.

Taxation finally ought not to be separated from other dealings between governments and citizens. It forms an inherent part of the endeavour to create a more fair and equitable society. Demand as well as supply for aggressive tax planning can be reduced by building a stable and predictable fiscal environment grounded on sound principles rather than complex rules.

## 1. HARMFUL TAX PRACTICES AND FISCAL COMPETITION

TAXE2 is the European Parliament<sup>1</sup>'s special committee on the application of Article 107(1) of the Treaty on the Functioning of the European Union regarding tax rulings and other measures similar in nature or effect. The committee is set up in particular to complete the work of its predecessor TAXE1 related to unresolved issues highlighted in the European Parliament's resolution of 25 November 2015<sup>2</sup>. The resolution explicitly mentions "the long-time secret page" of the 1997 Krecké report in which current Commission President Jean-Claude Juncker, then premier of Luxembourg, was asked to closely monitor the Luxembourg fiscal authorities' practice of providing multinational corporations (MNC) with secret rulings.

What is at stake are harmful tax practices defined by the European Parliament's resolution as "measures aimed at attracting non-resident firms or transactions at the expense of other tax jurisdictions in which these transactions should normally be taxed and/or measures aimed at privileging only some companies, [...] connected to one or several of the following undesirable effects: lack of transparency, arbitrary discrimination, distortions of competition and an uneven playing field within and outside the internal market, an impact on the integrity of the single market, and on the fairness, stability and legitimacy of the tax system, more taxation on less mobile economic factors, increased economic inequalities, unfair competition between states, tax base erosion, social dissatisfaction, mistrust and a democratic deficit". In essence, harmful tax practices refer to fiscal competition for investment capital or for countries to be considered as "hubs through which to channel financial flows or in which to book profits".

International taxation in general, and in the European Union in particular, is to a large extent a coordination game. Progress to harness the interdependence of national tax systems has long been stymied because Member States continue to believe "they have more to gain individually from loopholes in the uncoordinated tax system than they would collectively in a coordinated one."

On 28 January 2016, the European Commission launched its Anti-Tax Avoidance Package to coordinate the European Union's response to aggressive tax planning (ATP) and subscribe to the standards developed by the OECD in its action plan on Base Erosion and Profit Shifting (BEPS). As a first element in that package, on 8 March 2016 the Council drafted a directive to implement the OECD Action 13 requiring MNC to report tax-related information on a country-by-country basis, and requiring national tax authorities to automatically exchange such information<sup>3</sup>. The directive would cover MNC with a total consolidated group revenue of at least 750 million EUR. The Council estimates that although the measure only pertains to 10-15% of MNC, these groups account for 90% of corporate revenues.

Aggressive tax planning is not the prerogative of MNC. High net worth individuals and households (HNW) represent a significant share of demand too. Estimates of HNW tax evasion are by nature difficult to come by. Annual revenue loss for the U.S. has been

<sup>1</sup> European Parliament decision of 2 December 2015 on setting up a special committee on tax rulings and other measures similar in nature or effect (TAXE 2), its powers, numerical strength and term of office.

<sup>2</sup> European Parliament resolution of 25 November 2015 on tax rulings and other measures similar in nature or effect. The quotes in the following paragraphs refer to this resolution as well.

<sup>3</sup> European Commission (2016), *Proposal for a Directive amending Directive 2011/16 as regards mandatory automatic exchange of information in the field of taxation*, COM(2016)25.

estimated to lie in the range from 40 to about 70 billion<sup>4</sup>. Similar estimates may apply to the European Union which would compare with the estimated revenue losses for the EU as a result of corporate tax avoidance<sup>5</sup>.

Next to the disclosure on 5 November 2014 by the International Consortium of Investigative Journalists (ICIJ) of hundreds of Luxembourg corporate tax rulings, whistleblowers have come forth to expose the financial sector's role in tax planning for HNW. Notable cases involve UBS, Credit Suisse or HSBC but the United States Offshore Compliance Initiative for example involves many more financial institutions. At the time of writing, the ICIJ made public the consortium had obtained millions of files related to the Panama-based incorporation agent Mossack Fonseca detailing more than 200,000 offshore entities incorporated in various tax havens, in some cases on behalf of politically exposed persons and other high net worth individuals.

Although the nature of their situations varies widely, HNW share a number of characteristics that are important to fiscal authorities. Tax residency (and/or domicile) is a mobile concept despite the fact that the proximity of family, education and other services dominates the decision. There is not only an "intensive" risk of reduced tax revenue, there is also the "extensive" risk of missing out on revenue entirely.

Second: most HNW cannot always be deemed sophisticated in terms of financial, legal or tax advisory services, but they do have the resources to source in such expertise.

Third: the growing attention for inequality in society has brought the tax contribution of in particular the top-percentiles of citizens into the limelight. There is a "demand" and a "supply" side to this issue. HNW are urged not to dodge taxes on moral and ethical grounds. In return government is pressured to provide for a fair, efficient, transparent and equitable taxation system – and for government itself to function according to these standards.

At least since the eighties, the symbiosis of financialisation, globalisation and digitisation is threatening the very concept of nationally organised fiscal revenue bodies. Multinational corporations (MNC) and high net worth households (HNW) together with their global financial service providers have uprooted the financial as well as the fiscal system. Capital flows transit literally at the speed of light between jurisdictions. Governments and their international institutions have to follow suit and develop extensive forms of cooperation to curb or capture funds crossing borders.

Commercial and investment banks, insurance companies, wealth managers and other financial service providers cater to every need of MNC and HNW to channel these capital flows in the most efficient way. Considerations of corporate and investment strategy lie at the basis of the design of these mechanisms. Business models, financial instruments and portfolio construction have grown increasingly complex and sophisticated. But it is clear that the fiscal treatment of funds transfer in the source country and the destination country has a considerable impact as well.

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<sup>4</sup> Joseph Guttentag and Reuven Avi-Yonah (2005), *Closing the International Tax Gap*, In: Max B. Sawicky, ed., *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration*, Washington, DC, Economic Policy Institute. Compare with Gabriel Zucman's estimate of a revenue loss of 36 billion USD for tax evasion related to financial investments. See Gabriel Zucman (2014), *Taxing Across Borders: Tracing Personal Wealth and Corporate Profits*, *Journal of Economic Perspectives* 28.4, pp. 121-148.

<sup>5</sup> European Parliamentary Research Service (2015), *Bringing transparency, coordination and convergence to corporate tax policies in the European Union: I – Assessment of the magnitude of aggressive corporate tax planning*, September. The study estimates the revenue losses due to profit shifting alone at 50-70 billion EUR per annum. Including other corporate taxation issues, the losses could amount to around 160-190 billion EUR.

The varying speed with which tax and legal systems in various countries adapt to – one should arguably say pursue or remedy – these complex developments, inevitably creates paths of least resistance that are efficiently identified and put to use by financial advisors on behalf of their corporate and private clients.

To some extent, the pace of development implies a fiscal environment that is constantly in flux. Such a habitat incentivises sophisticated taxpayers that are less averse to risk to adopt a « probabilistic » tax strategy in which the *ex post* realised outcome may not be fully predictable *ex ante*. Advance disclosure requirements may restrain the risk appetite and at the same time further fiscal authorities' understanding of developments in the market for tax advisory services.

In the wake of its Seoul Declaration in 2006 to counter « unacceptable tax minimisation arrangements », the OECD identified two areas of concern for revenue bodies with respect to aggressive tax planning<sup>6</sup>. First: tax positions may be tenable but have unintended and unexpected consequences from the point of view of the legislator. Secondly, a taxpayer can entertain a tax position without disclosing his or her view on the uncertainty as to whether the tax return complies with the law.

Financial institutions, and banks in particular, are well-placed to be solicited in aggressive tax planning. They have access to the significant amounts of capital implied, in some cases for only a very limited period of time, in large-scale arrangements. Their network of entities across multiple jurisdictions provides the conduit for these funds. Their ability to tailor often extremely complex financial securities can respond to any conceivable tax planning demand.

Of course, the involvement of the financial sector can be as limited or passive as establishing *bona fide* bank accounts. At the other extreme, financial institutions can actively reap or join in the tax benefits themselves. For most of the ATP schemes in the *catalogue raisonné* of this study, a business or personal rationale could be envisaged wherein tax considerations do not dominate. But on a very general level, the common denominator is the deliberate exploitation of loopholes created by the imperfect international consistency and coordination of tax rules or fiscal compliance reinforcement efforts.

The lack of consistency and coordination concerns several dimensions, such as issues related to the pricing of financial instruments and intangible assets, the qualification of corporate and personal income categories, and the verification of the identity of the ultimate beneficial owner of corporate entities or financial accounts. In the following sections we will discuss these dimensions and indicate how they were exploited, specifically when financial intermediaries were involved. In order to do so, we must first consider the decisive factor that, almost by definition, *location* plays a fundamental role in international taxation.

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<sup>6</sup> OECD (2008), *Study into the role of tax intermediaries*. This study must be read in conjunction with OECD (2009), *Building transparent tax compliance by banks* and OECD (2009), *Engaging with High Net Worth Individuals on Tax Compliance*.

## 2. LOCATION-BASED TAXATION

### 2.1. The country allocation of taxing rights

The principles of the current system of international taxation were laid down in the years after the first World War<sup>7</sup>. The United States Revenue Act of 1918 allowed, for the first time in the world, a credit instead of a deduction against U.S. income taxes for taxes paid by a U.S. citizen or resident to a foreign fiscal revenue body for income earned outside the United States. In 1923, the Rome Resolutions of the International Chamber made an inroad towards formulary apportionment (cf. *infra*). Half a decade later, in 1928, the League of Nations drafted a bilateral income tax treaty model for the relief of double taxation that still serves as the basis for the current treaties.

Ever since that time, the discussions in international taxation focus on the wedge that any fiscal system drives between global and national welfare. The principle that people ought to pay equal income taxes regardless of the source country of that income, and the principle that all investments in a particular country should face the same burden irrespective of whether the investment is made by a citizen of that country or a foreign person are only reconcilable when (capital) income is taxed identically across the globe. Absent such a universal rule, every fiscal legislation is a particular choice of compromise between these principles.

International taxation thus revolves around the coordination and allocation of taxing rights among countries. Proponents of residence-based taxation point out that the crucial determinant of taxation is the overall ability of the taxpayer to pay. Source-based taxation argues that the use of government-provided facilities in the country where income is actually generated must at least partially be compensated for.

Residence-based and source-based taxation both have legitimate albeit competing claims; the objective is to avoid having income doubly taxed. As source-based taxation precedes residence-based taxation, this may not be straightforward. To mitigate the risk of double taxation and a “race to the bottom” by source countries, countries of residence are inclined to go for either exempting foreign source income or allowing a foreign tax credit. The United States is a problematic example in that the ability of U.S.-owned corporations abroad to – for all intent and purposes indefinitely – defer tax on foreign income introduces a source-based-like characteristic in its fiscal system.

Whether countries are or would want to be net exporters or importers of capital determines to a large extent the choice of tax system. Exporters have most to gain from taxing residents. Worldwide efficiency would imply that taxpayers ought to be indifferent about investing domestically or abroad when confronted with the same pre-tax rate of return. Such a residence-based system is said to exhibit capital export neutrality. The European Union’s project to complete the internal market similarly proclaims that taxes ought not to distort investment allocation decisions. The concept of foreign tax credits attempts to do away with potential distortions. If a U.S. investor for example would invest in a low-tax-rate jurisdiction, the foreign tax credit ensures that her foreign source income is taxed at a rate equal to the excess of the U.S. rate over the foreign rate and double taxation is avoided.

Of course, allowing unlimited credit for foreign taxes opens the way for abusive transfer pricing where profit is shifted to foreign subsidiaries. The thousands of (bilateral) tax

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<sup>7</sup> For more historical perspective, see Michael J. Graetz (2001), *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax Law Review, pp. 261-336.

treaties in place, most of them ultimately based on the League of Nations model, allocate to source countries the rights to tax active business income provided a “permanent establishment” is shown to exist; and to residence countries taxing rights over passive income, such as dividends, royalties and interest, in some cases subject to withholding tax. It is this constellation that is critical to understanding aggressive tax planning schemes.

Countries that must compete to attract foreign capital, be it in the form of portfolio or foreign direct investment, will want to avoid withholding tax on interest paid by domestic corporations (or their country’s Treasury) to foreign investors. We refer to the European Union’s Interest and Royalties Directive and the Parent/Subsidiary Directive, as amended from time to time. But enforcing residence-based taxation of portfolio income is not without difficulties, and withholding taxes may be the only practical way to impose some taxation on foreign source portfolio income. The European Parliament<sup>8</sup> itself stressed the need “to ensure that outgoing financial flows are taxed at least once, for instance by imposing a withholding tax or equivalent measures.” Many aggressive tax planning schemes involving the tax-free repatriation of funds simply would not work in the presence of comprehensive withholding taxes.

The contender to capital export neutrality is capital import neutrality that favours taxation at source, irrespective of the nationality of the business owners. In the 1920’s the debtor nations of continental Europe fiercely defended such “neutrality” against the (capital-exporting) British. The system would exempt foreign corporate investment from tax, but continue to tax portfolio investment. For such a system to be neutral, let alone efficient with respect to investment decisions, capital would have to be completely immobile across borders while corporations continue to differ (and compete for investors) in productivity. The first assumption obviously is not valid. The second is contradicted by the significant home bias in portfolio (and direct) investment: productive efficient firms are not excluded from portfolios because of tax considerations.

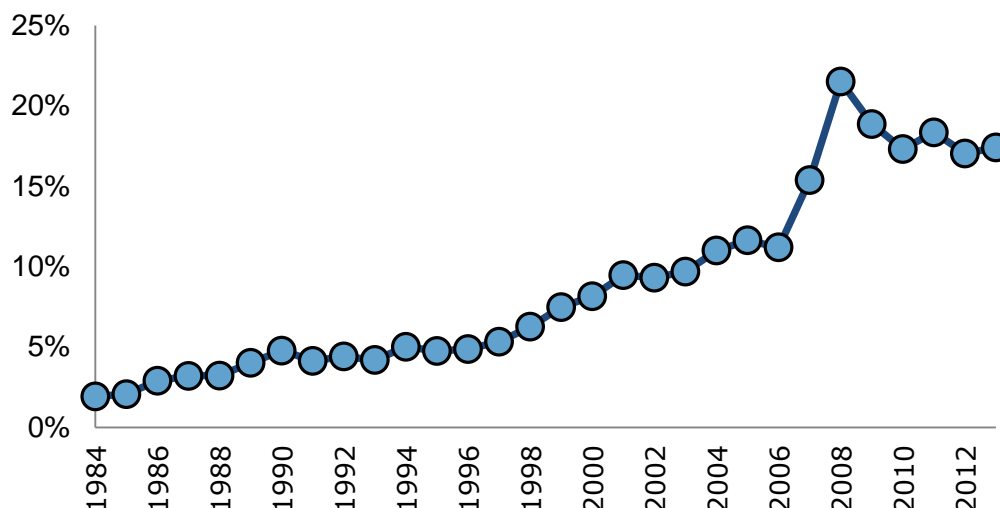
Arguably, this element of source-based taxation is a direct cause of most of the avoidance and evasion schemes, whether it involves treaty shopping, abuse of transfer pricing or the establishment of offshore shell corporations. Source-based taxation results in higher returns in low-tax-rate countries. The high-tax country may suffer from capital flight and lower wages until after-tax returns among jurisdictions are equilibrated. In this respect, academics have painted stark pictures of tax havens acting as “parasites”<sup>9</sup> on non-tax-haven countries.

To give but one example, of the approximately 700 billion USD of foreign profits of U.S. corporations, more than half derive from six “source” countries: the Netherlands, Bermuda, Luxembourg, Ireland, Singapore, and Switzerland – six jurisdictions preferred among taxpayers as either “transit” countries for capital flows or hubs for tax-efficient incorporation.

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<sup>8</sup> European Parliament resolution of 25 November 2015 on tax rulings and other measures similar in nature or effect.

<sup>9</sup> Joel Slemrod and John D. Wilson (2009), *Tax competition with parasitic tax havens*, Journal of Public Economics 93(11-12), pp. 1261-1270.

**Figure 1: The share of the top-six tax efficient domiciles in total U.S. corporate profits**

**Source:** Adapted from Gabriel Zucman (2014), Figure 3.

A whole arsenal of rules have been introduced to mitigate the most damaging side effects of the twentieth-century fiscal system. Controlled Foreign Company (CFC) rules for example were first introduced in the 1960s to capture at least some of the “diverted” income. The Court of Justice of the European Union has generally speaking weakened some of the modalities of CFC regimes in Member States, as did the “check-the-box” regulations in the U.S. Yet CFC rules are decisive in countering aggressive tax planning schemes by capturing a (foreign) subsidiary’s income that had escaped taxation.

To complete our brief overview of taxing rights allocation, the notion of “national” neutrality applies to a system that resembles the early days of income taxation: worldwide income is subject to tax but (only) with a deduction for foreign taxes paid. In such a system, the country favours domestic investment over equally productive foreign investments. The home country in effect profits from the tax revenue as well as from the after-tax return accruing to its residents, in the process capturing the entire pre-tax return. Foreign taxes are treated as a cost of investing capital abroad. If capital would be perfectly mobile, national neutrality would effectively imply that a country’s total income (including after-tax profits and tax revenue) is comparable across jurisdictions. There is a consensus among scholars that national neutrality as opposed to worldwide efficiency in the end may be self-defeating.

Since the 1920’s, the conceptual distinctions between source and residence country, or active and passive income have continued to become blurred. In a digital market, the country in which profits are generated has come to coincide with where the consumers are, rather than where the “bricks and mortar” reside. The growing importance of intangible assets has allowed MNC to consider or “transform” passive income as active. With the explosion of portfolio investment since the 1980’s, and the prolific establishment of foreign subsidiaries, the share of foreign equity in portfolios and international capital flows among those entities boomed. Tax legislation has a hard time pursuing these evolutions. Academics have voiced their concerns that initiative such as the OECD’s BEPS do no more



than seeking to close loopholes rather than to re-examine the fundamental issues. Calls for a complete overhaul of the fiscal system grow louder<sup>10</sup>.

A useful overview of corporate taxation is provided in the following table<sup>11</sup>. The two dimensions are (1) the corporate income base that is taxed, ranging from the excess rent on equity investment to the return on total capital; and (2) the geographic dimension, comparing source-based taxation with residence- and destination-based taxation.

**Table 1: Two dimensions of corporate taxation**

<b>Tax base</b>	<b>Excess rent on equity</b>	<b>Return on equity</b>	<b>Return on total capital</b>
<b>Source country</b>	Cash flow taxation <i>or</i> Allowance for Corporate Equity	Exemption for foreign source income	Comprehensive income <i>or</i> Dual income taxation
<b>Residence country (of shareholders or corporation)</b>		Personal capital income taxation <i>or</i> Credit for foreign taxes paid	
<b>Destination country (of final consumption)</b>	VAT-type <i>or</i> Cash flow taxation		

**Source:** Adapted from table 1 in Alan Auerbach, Michael Devereux & Helen Simpson (2011).

The most common form of corporate taxation is represented by the top row middle column: a source-based tax on the return accruing to the shareholders, with an exemption for foreign source income. It is well-known that the relief for debt finance creates distortions. To mitigate these distortions, two alternative source-based tax treatments can be considered: either the tax base is narrowed by allowing relief for equity finance as well (moving to the left in the top row) or the tax base is enlarged to include total return on capital (moving to the right in the top row).

The cash flow proposal taxes all positive and negative cash flows at the same rate, thus leaving the normal rate of return untouched and taxing only excess profits, i.e. economic rent. A serious drawback of such a system is that government would typically subsidise investments, as the latter initially give rise to negative cash flows, implying negative tax payments. A variant that has received quite some attention, both from scholars and the general public, involves an allowance for corporate equity<sup>12</sup>. Rather than providing upfront

<sup>10</sup> See for instance Michael Devereux and John Vella (2014), *Are we heading towards a corporate tax system fit for the 21st century?*, Fiscal Studies 35.4, p. 449-475.

<sup>11</sup> Adapted from : Alan Auerbach, Michael Devereux, and Helen Simpson (2011), *Taxing corporate income*, in: Institute for Fiscal Studies, *Dimensions of tax design. The Mirrlees review*, p. 837-893, Oxford: Oxford University Press.

<sup>12</sup> IFS Capital Taxes Group (1991), *Equity for companies: A corporation tax for the 1990s*, Commentary 26. The seminal paper is Robin Boadway and Neil Bruce (1984), *A general proposition on the design of a neutral business tax*, Journal of Public Economics 24(2), p. 231-239.

relief for investment expenditures, additional relief is given in the form of a deduction for “notional” interest on equity that exactly compensates for the delay in receiving depreciation allowances.

The other road sometimes taken is to do away with the deductibility of interest expenses entirely and tax comprehensive corporate income. A variant here is the dual income tax popularised by some of the Scandinavian countries. A low tax rate on capital income – to attract inward investment – is combined with progressive taxation of labour income. The potential distortion here concerns the different treatment of personal and corporate income.

Residence-based taxation ought to aim to levy taxes as profits accrue, not as they are repatriated to corporate headquarters. Such a system has the advantage of not distorting where and how much corporations are active. The implementation issues however are considerable if not insurmountable, both at the level of the individual shareholder but also at the corporate level.

The third alternative of destination-based taxation levies taxes where the sale to a final consumer takes place – compare formulary apportionment including sales as a criterion (cf. *infra*). A destination-based system would avoid the crucial distortions encountered in a source-based or residence-based system, and a fortiori in the current hybrid fiscal systems. The question is how the costs of producing those goods are treated when the sales involve imported goods and these costs are not included among the apportionment criteria. An option would be to relieve those costs in the (source) country where they are incurred, and to exempt exports but not imports, as in the case of VAT. If in addition relief would be provided for labour costs, a full cash flow tax would result.

The two dimensions in the table relate respectively to the difficulties of whether and how to isolate where the taxable profit of a corporation is located, and the extent to which corporate and personal income taxation are interdependent. After all *any* form of taxation, be it a corporate or consumption or wealth tax, ultimately falls on the individual taxpayers that provide the income-generating factors of either labour or capital. The increasing mobility of in particular capital and the cross-ownership of corporate capital across borders rapidly diminishes the case for source-based corporate taxation relative to taxing capital providers in their residence country. Still, national fiscal authorities cling to the conviction that they are justified to tax at source for the facilities their country provides to foreign MNC. But how unique to their country are these facilities, and the economic rents that accompany them?

The table above suggests that the problems are not limited to corporate taxation. When discussing taxation from a HNW point of view: if corporate taxation is only a way to capture (or prepay) personal income tax, how will the fiscal system integrate corporate and personal taxes, say by letting corporate tax returns as a credit offset residence-based personal income tax liabilities? To the extent that corporate taxation fulfills other functions, in particular to capture and tax economic rents largely tied to the country in which the business operates, how will the fiscal authorities reconcile these source-based aspects with the residence-based nature of personal income taxes?

## **2.2. Tax havens as sources and sinks of international capital flows**

There is no generally accepted definition of a tax haven. Various characteristics do return in the working definitions that circulate<sup>13</sup>: low tax rates if any taxation applies at all, secrecy

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<sup>13</sup> The OECD provided a milestone with OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*. Compare with the criteria in the European Commission Recommendation of 6 December 2012.

with respect to the identity of the ultimate beneficial owners of corporate entities and bank accounts, and lack of transparency in the financial services rendered.

The BEPS initiative of the OECD succeeds in convincing more and more jurisdictions to comply with its requirements for information exchange. Its Global Forum on Transparency and Exchange of Information for Tax Purposes has at the time of writing completed 225 peer reviews and assigned compliance ratings to 94 jurisdictions that have undergone Phase 2 reviews to join the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. 132 jurisdictions have agreed to exchange information “on request”, of which 96 will introduce automatic exchange of information within the next 2 years.

As a result, the discussion concerning tax haven status is evolving towards an assessment of the aggressivity with which fiscal competition is conducted. A number of countries in Europe for instance – the Netherlands, Luxembourg, Hungary to a smaller extent – are world-leading strongholds with respect to the establishment of Special Purpose Vehicles that are used as “tax-efficient” cash flow conduits in ATP schemes. Other offshore jurisdictions specialise in mutual funds (Luxembourg), money market funds (Ireland) or hedge funds (Cayman Islands). Still others such as the British Virgin Islands, Panama or Hong Kong house hundreds of thousands of shell (and sham) corporations.

The few “winners” of global tax competition present disproportionate economic and financial metrics relative to their size and (real) economic activity.

**Table 2: Economic and financial metrics of selected tax havens**

Description	Selected tax haven	Metric
Registered corporations per address	Ugland House, George Town (Grand Cayman)	> 18,000
Registered corporations per address	1209 North Orange Street, Wilmington (Delaware, USA)	> 285,000
Foreign Direct Investment inflow to GDP (2012)	British Virgin Islands	80%
Origin of FDI stock share in Brazil (2012)	The Netherlands	28%

**Source:** Ugland House website; Leslie Wayne (2012), *How Delaware Thrives as a Corporate Tax Haven*, New York Times, June 30; UNCTAD FDI/TNC database.

To put the last number in perspective: in 2012, the British Virgin Islands were the fifth largest FDI recipient in the world. The inflow was 50% larger than the United Kingdom enjoyed, an economy that is almost 3,000 times larger. Close to a third of cross-border corporate investments are channeled through offshore jurisdictions<sup>14</sup>. Mauritius for instance in 2012 was the source country of 44% of India’s inward direct investment<sup>15</sup>.

Service trade with tax havens is approximately six times larger than with comparable countries whereas no such difference exists in goods trade<sup>16</sup>. Not only is the financial

<sup>14</sup> UNCTAD (2016), *World Investment Report 2015 : Reforming International Investment Governance*.

<sup>15</sup> UNCTAD FDI/TNC database, based on data from the Reserve Bank of India.

<sup>16</sup> Shafik Hebous and Niels Johannesen (2015), *At Your Service! The Role of Tax Havens in International Trade with Services*, CESIFO Working Paper No. 5414.

services industry, of course, extremely developed in certain offshore locations; aggressive tax planning by MNC and HNW goes beyond such specialisation. Research suggests these services are overpaid in an attempt to shift profit to low-tax-rate jurisdictions. Hebous and Johannesen find evidence of “positive excess imports” from affiliates in tax havens in four major service categories: the management of intangible assets and headquarter services, information services and marine transport.

### **2.3. How much HNW financial wealth is held offshore?**

It is estimated that about 6-8% of HNW financial wealth is held offshore, the estimates ranging from only about 1% in Japan, 7% in Europe to maybe 30% in Latin America, the Middle East and Africa. In total, offshore wealth amounts to approximately 10 trillion USD<sup>17</sup>.

We highlight one method of estimation, as it is directly related to the financial sector. Zucman<sup>18</sup> made use of an anomaly in international capital statistics – the stock in the international investment position and the flows accounted for in the global balance of payments – to estimate offshore wealth. It has been well-known since at least the seventies that the world as a whole appears to be a net debtor<sup>19</sup>. Recorded liabilities exceed assets. Or put otherwise: for many securities outstanding, the owner cannot be ascertained. If the global record of portfolio liabilities is assumed to be correct, then the gap between reported assets and the total amount of liabilities provides an estimate of the assets held offshore.

A country’s cross-border investments recorded in its international investment position consist of direct investments, portfolio securities, and other assets such as loans and deposits. (A fourth category represents reserve assets held by central banks.) International investment statistics are residence-based, meaning that a share issued by a German corporation and held by a French household through a Swiss bank must be recorded as a liability of Germany and correspondingly an asset to France. Germany will duly record a liability, albeit incorrectly vis-à-vis Switzerland. As the shares are held by a Swiss custody bank, they will not show up as assets in the records of the French custodians. Importantly, they do not appear on Switzerland’s investment position either as they are neither assets nor liabilities for Switzerland.

The gap between reported assets and the total amount of liabilities was ca. 4,5 trillion USD in 2008, which must represent a lower boundary for the correct figure in view of the financial market meltdown in the final quarter of that year. It is worth noting that close to half of the wealth unaccounted for represents claims on investment funds incorporated in Luxembourg (mutual funds), Ireland (money market funds) and the Cayman Islands (hedge funds).

Zucman points out that since 1998 the Swiss National Bank does publish the value of the offshore portfolios held in custody by Swiss banks. In fact, the vast majority of all foreign securities held by these institutions do not belong to Swiss investors. Furthermore, the Swiss National Bank also records the amounts in so-called fiduciary deposits held in Switzerland on account of foreigners. These deposits are called fiduciary because the Swiss banks invest the funds placed in foreign money markets on behalf of the deposit holders.

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<sup>17</sup> Boston Consulting Group (2015), *Global Wealth 2015: Winning the Growth Game*.

<sup>18</sup> Gabriel Zucman (2013), *The missing wealth of nations: Are Europe and the U.S. net debtors or net creditors?*, Quarterly Journal of Economics 128(3), p. 1321–1364.

<sup>19</sup> Philip R. Lane and Gian Maria Milesi-Ferretti (2007), *The external wealth of nations mark II: Revised and extended estimates of foreign assets and liabilities, 1970–2004*, Journal of International Economics 73, November, 223-250, updated and extended.

Since interest is considered to be paid by these foreign actors to the depositors, the Swiss banks are technically acting merely as fiduciaries and the deposits are exempt from Swiss advance taxation. More than half of fiduciary deposits belongs nominally to entities in the British Virgin Islands, Jersey, and Panama. Together, these numbers suggest that more than two and a half trillion USD of offshore wealth is held in Switzerland.

Based on interviews with offshore wealth managers, the Boston Consulting Group believes the Swiss share would now represent about a quarter of the global offshore wealth, down from a third in 2008. Traditional strongholds such as Luxembourg or the Channel Islands have lost market share due to the enforcement initiatives in the Old World, and the vigorous growth in wealth, onshore and offshore, in Asia or Latin America. Although the majority of offshore wealth is still in European or American hands, the developing world will soon overtake the Old World.

**Table 3: Distribution of global offshore wealth over selected centres**

Centre	Offshore wealth (trillions USD)	Share
Switzerland	2,4	24%
Caribbean and Panama	1,2	12%
Channel Islands and Dublin	1,2	13%
United Kingdom	1,1	11%
Singapore	1,0	10%
United States	0,7	7%
Luxembourg	0,6	6%
Hong Kong	0,5	6%
Other	1,2	12%

**Source:** BCG Global Wealth Market-Sizing Database, 2015.

The upshot, Zucman argues, is that the negative net foreign asset position of the developed world is “an illusion caused by tax havens.” The portfolios European and American households own via banks in Switzerland and tax havens are not covered in the official statistics. Uncovering these portfolio accounts – representing about 6 to 8% of total household financial assets – would render the United States and Europe again net creditors.

#### **2.4. Negative spillover from harmful tax practices on developing nations**

The negative spillover effects of harmful tax practices appear to be far more significant on developing countries than on developed countries<sup>20</sup>. An IMF study tentatively suggests that developing countries lose in relative terms three times as much revenue to aggressive tax

<sup>20</sup> Ernesto Crivelli, Ruud De Mooij and Michael Keen (2015), *Base erosion, profit shifting and developing countries*, IMF Working Paper 118.

planning as developed countries, taking into account the fact that high-income countries collect on average 30-40 percent of GDP in taxes and other contributions, whereas low-income countries half that percentage.

Furthermore, developing countries rely much more heavily on corporate taxes: at approximately 20 percent of total taxes, they are nearly twice as important. The United Nations Conference on Trade and Development (UNCTAD) estimates that about a quarter of corporate taxes in developing countries derive from foreign affiliates: 730 billion USD annually<sup>21</sup>.

Whereas coordinated efforts to counter aggressive tax planning appears to reduce the share of offshore investments in developed countries, developing countries' exposure continues to rise. As we saw in the example of Mauritius, specific jurisdictions function as preferential (transit) investment hubs for their region, here Africa and India. Cyprus is similarly the gateway to the Russian Federation. Offshore hubs form an inherent part of the worldwide financing of foreign direct investment. UNCTAD suggests that a higher exposure to offshore hubs correlates with a lower return on foreign direct investment, which may be symptomatic of a profit shifting motive in these transactions. The end result is that aggressive tax planning skews the distribution of global profits towards a more unfair world.

Globalisation incentivises MNC to continuously assess the profitability in each of the links in its worldwide value chain. This quest for low-cost production locations is highly sensitive to tax considerations. Rather than the low tax rate per se, it is the tax base that ranks high as an investment criterion. The effective average tax rate measuring the differential in pre- and after-tax net present value of a (real) investment project to a large extent determines location; conditional on location, the effective marginal tax rate will guide the optimal scale of investing<sup>22</sup>. The manner in which transfer pricing and cross-border transactions in general can be optimised for fiscal impact is a decisive determinant of both.

## **2.5. Aggressive tax planning schemes – Location**

### **2.5.1. Investing in mutual funds through a tax haven account**

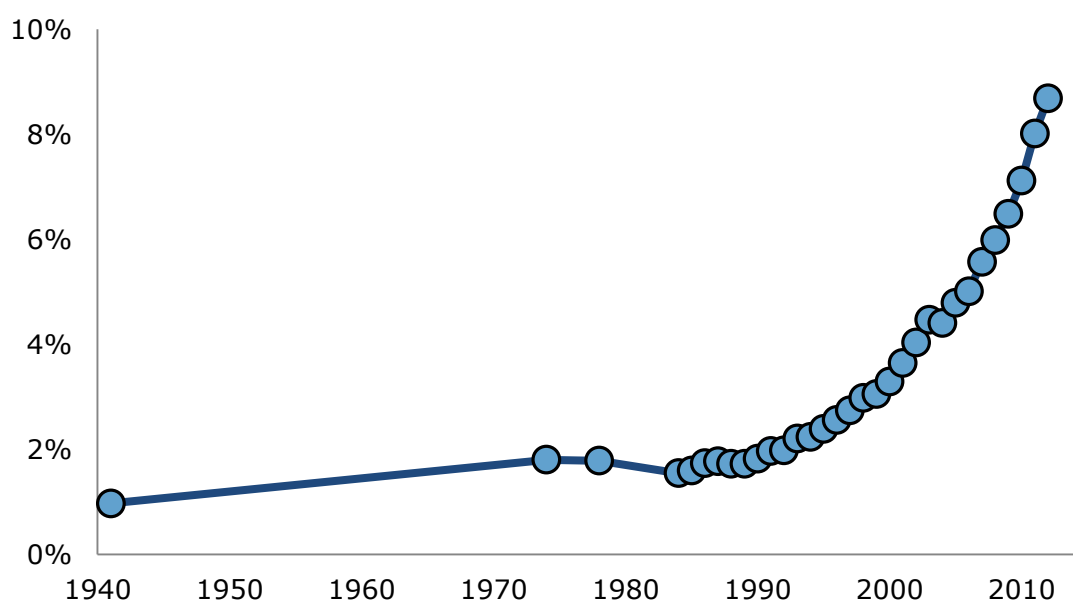
A Belgian resident investing in a Luxembourg-domiciled mutual fund through his or her Swiss account creates an opportunity to avoid or evade taxes. If Luxembourg does not withhold taxes on cross-border payments, the Belgian will receive the full dividends distributed by the fund on his or her Swiss account. The Belgian fiscal authority needs to depend on being informed by the Swiss banks of the presence of such account.

There has been a steady rise in the share of developed market equity capitalisation held through tax havens – think hedge funds in the Cayman Islands, or mutual funds registered in Luxembourg. This trend has been accelerating since the mid-eighties. In 2012, 9 percent of the US listed equity capitalisation was held by tax haven investors.

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<sup>21</sup> UNCTAD (2016), *World Investment Report 2015 : Reforming International Investment Governance*.

<sup>22</sup> The seminal paper remains Robert E. Hall and Dale W. Jorgenson (1967), *Tax policy and investment behavior*, *American Economic Review* 57.3, pp. 391-414.

**Figure 2: The share of tax havens holdings in U.S. equity market capitalisation**

**Source:** Adapted from Gabriel Zucman (2014), Figure 6.

### 2.5.2. Double dip interest deduction

Corporation A borrows funds from a bank, writing the expense off against its income before taxes. The proceeds of the loan are invested in shares of a subsidiary residing in a low-tax rate jurisdiction. The subsidiary lends the funds on to another subsidiary in a high-tax rate jurisdiction where a second interest deduction occurs, outweighing the taxable interest income received by the low-tax rate jurisdiction subsidiary.

### 2.5.3. Double non-taxation

The counterpart of a double deduction – where the same cost is deducted in the source country and in the residence country – is of course double non-taxation – where income that is not taxed in the source country is exempt in the residence country.

### 2.5.4. Partner hip/corporation hybrid<sup>23</sup>

An offshore entity may be regarded as a partnership in country A where the tax characteristics pass through to the partners whereas the same entity is taxed as a corporation in country B.

### 2.5.5. Shifting foreign tax credits

Through the bank's introduction of an offshore entity, an unclaimed foreign tax credit can be shifted. A corporation or financial institution in a high-tax rate jurisdiction that is unable to claim a tax credit sells dividend rights to the offshore entity. The tax credit is then claimed against the dividend income, in the process eliminating the tax on the latter. Any remaining credit can then shelter unrelated bank income from taxation.

<sup>23</sup> OECD (2008), *Study into the role of tax intermediaries*.

#### 2.5.6. « Permanent establishment » avoidance schemes

Legislators typically want to levy taxes in the location where economic substance is present and a fixed place of business or « significant digital presence »<sup>24</sup> can be identified, rather than relying on formal rules to determine residence or source. Offshore entities that are for all intents and purposes managed and operated out of the host country should not be allowed to claim foreign status and enjoy the tax benefits that come with that status.

Conversely, MNC can attempt to exploit CFC look-through rules to render an offshore subsidiary invisible for tax purposes to avoid for example the taxation of foreign portfolio income.

#### 2.5.7. Swap payments received as non-taxable foreign source income

A swap is a financial instrument in which the parties agree to exchange a series of cash flows on specific dates in the future, with the payments linked to the performance of underlying financial indices such as foreign exchange rates or commodities prices, and/or to the realisation of specific events such as a credit default. The notional values underlying the global swap market is estimated at more than 600 trillion.

Under U.S. Treasury regulation dating from 1991, a swap payment from the United States sent offshore is regarded as *foreign* source income and consequently probably not taxable. U.S. corporations, including in particular financial institutions such as hedge funds channeled billions of dollars out of the country through the loophole by means of establishing entities in offshore locations.

#### 2.5.8. Mutual funds routing commodity activities through offshore shell corporations

United States regulation exempted mutual funds from corporate income taxes, as long as no more than 10% of its income derived from alternative investments, and commodities speculation in particular. Since 2006, the IRS has approved a number of schemes by which mutual funds can invest more substantially in commodities without losing preferential fiscal treatment. One of the methods allowed involves the mutual fund establishing an offshore corporation to invest in commodities the income of which is considered income from non-alternative securities investment, specifically investment in the equity shares of the offshore entity.

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<sup>24</sup> See the OECD/G20 Base Erosion and Profit Shifting Project (2015), in particular *Action 1: Addressing the Tax Challenges of the Digital Economy*.



### 3. TRANSFER PRICING AT ARM'S LENGTH

#### 3.1. Nothing really compares

Any attempt to apply source-based taxation of corporate income for an MNC runs into the problem of defining the contribution of each of the various "source" companies in the group. Consider a group that owns production facilities in country A, making use of proprietary technology developed and held by R&D subsidiaries in countries B and C, and whose goods are marketed through subsidiaries D through F to the global consumer market. At least the countries A, B and C qualify as source country and a comprehensive assessment must consider the arm's length price of their contribution – a daunting task if at all meaningful.

The European Commission<sup>25</sup> notes that 72% of profit shifting in the European Union makes use of transfer pricing and tax-effective location of intellectual property (innovation boxes, intellectual property boxes, knowledge boxes, patent boxes, etc.). The estimate squares with the OECD's earlier observation that 60% of world trade takes place within MNC groups<sup>26</sup>.

The proliferation of services involving the use of (intangible) assets will make transfer pricing at arm's length an ever more challenging exercise. At the heart of the arm's length principle lies finding a comparable transaction. The OECD's Transfer Pricing Guidelines<sup>27</sup> set forth the attributes that may be important in determining whether two transactions are comparable. These include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties to the transaction.

The already sensitive balance between the formal and functional characteristics of the asset transferred is even more pronounced when intangible assets such as trademarks are involved. No two "brands" are used to add value in the same manner by their respective owners. Especially the risk component of the functional comparison exercise has given rise to quite some divergence in interpretation. The OECD advocates to look at the conduct of the parties involved to see whether the purported allocation of risk is consistent with the economic substance of the transaction (cf. *infra*). As a result, there are quite some degrees of freedom in the application of the arm's length principle.

Finally, the economic circumstances and business strategies pursued imply that the arm's length pricing can differ from market to market and from cycle to cycle, even if the same goods or services are involved. The end result is that MNC tend to ask for a ruling by the fiscal revenue body to obtain comfort with respect to business-critical transfer pricing arrangements – which arguably defeats the purpose of having transfer pricing guidelines in the first place.

#### 3.2. Is formulary apportionment an alternative?

The European Parliament, in its TAXE 1 resolution, believes that the so-called modified nexus approach for patent boxes, as recommended by the OECD's BEPS initiative, will not do away with the issues related to patent boxes. A more fundamental solution proposed to avoid the controversies around arm's length pricing is formulary apportionment, such as

<sup>25</sup> European Commission (2015), *Corporate Income Taxation in the European Union*, SWD(2015)121. The remaining profit-shifting schemes involve debt shifting.

<sup>26</sup> John Neighbour (2008), *Transfer pricing: Keeping it at arm's length*, OECD Observer 230, January 2002 (corrected 2008).

<sup>27</sup> OECD (2010), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

the implementation contemplated in the European Union's Common Consolidated Corporate Tax Base. Formulary apportionment allocates the profits of MNC to individual countries, based on criteria such as capital outlays, employment numbers, or sales<sup>28</sup>. Attempts to shift profit across jurisdictions would consequently be driven by the sensitivity to these criteria.

The challenge for legislators is to identify those criteria that allocate taxing rights among countries in an equitable manner. From an econometric point of view, the criteria ought to include those factors that explain a significant share of the variability in profitability<sup>29</sup>. If employment is included, the decision to hire and the decision to locate are interdependent and tax competition will take place on the crossroads of these dimensions. As we saw in the previous section, if only sales were used as a criterion, the risk of excess competition may be mitigated. From a global standpoint, it is not clear whether formulary apportionment, which is quite sensitive to the choice of criteria, would lead to a more fair distribution of taxing rights among countries<sup>30</sup>.

### **3.3. Aggressive tax planning schemes – Pricing**

#### **3.3.1. Shifting profit offshore through abusive transfer pricing arrangements**

Recently, a number of high profile cases of aggressive corporate tax planning received media attention.

IKEA was the subject of a Greens/EFA paper<sup>31</sup> which showed that already in 1973 Ingvar Kamprad established companies in Curaçao and Luxembourg to hold what is assumed to be IKEA intellectual property. By 1982 he had split IKEA in two: the Inter IKEA Group, under a Luxembourg holding company owned by the Liechtensteinian Interogo Foundation, and the IKEA Group, under a Dutch holding owned by a Dutch foundation, the Stichting INGKA.

The Liechtenstein construction is not subject to inheritance tax. But what interests us here is the Dutch conduit for royalties and interest payments. The crucial feature is that the Netherlands do not withhold taxes on such outgoing payments, even when the destination is a tax haven. As a result, a Dutch company is often "sandwiched" in aggressive tax planning schemes between other entities. Here, the Interogo Foundation sold the IKEA trademark to the Dutch holding for 9 billion EUR. The debt created to finance this considerable transaction allows to shift profits through tax-deductible interest payments.

Another prominent example is Google's "double Irish Dutch sandwich" aggressive tax planning<sup>32</sup>. The strategy derives its name from the interposition of Google Netherlands Holding BV between Google Holdings, incorporated in Ireland but managed out of its Bermuda residence, and Ireland Limited, a subsidiary of Google Holdings to which the latter licensed the use of Google's core technology. The United States parent had in fact transferred the corporation's search and advertising technology to Google Holdings in 2003, in anticipation of Google's initial public offering. Ireland Limited licenses on the technology to Google's affiliates in Europe, the Middle East and Africa. (For Asia, a similar construction

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<sup>28</sup> Apportionment is applied for instance to the individual states within the U.S. See Kimberly Clausing (2016), *The U.S. State Experience under Formulary Apportionment: Are There Lessons for International Tax Reform?*, National Tax Journal, June 2016 (forthcoming) for an appraisal.

<sup>29</sup> James R. Hines Jr. (2010), *Income misattribution under formula apportionment*, European Economic Review 54(1), pp. 108-120.

<sup>30</sup> IMF (2014), *Spillovers in International Corporate Taxation*, IMF Policy Paper, May 9.

<sup>31</sup> Marc Auerbach (2016), *IKEA: flat pack tax avoidance – TAAKS AVOYD*, Commissioned by the Greens/EFA Group in the European Parliament.

<sup>32</sup> Jesse Drucker (2010), *Google 2.4% Rate Shows How \$60 Billion Is Lost to Tax Loopholes*, Bloomberg, October 21.

is set up in Singapore.) Ireland Limited in turn wants to pay royalties to Google Holdings “in” Bermuda where corporate income goes untaxed. But because Ireland withholds taxes on royalty payments to Bermuda, the money first goes – tax-free – to the Dutch shell company. Google Netherlands Holding BV then hands over the funds to the Bermudan holding with one crucial detail: to the Dutch fiscal authorities, Google Holdings is Irish! Finally, to ensure that the United States IRS would not tax the royalty stream, both Ireland Limited and Google Netherlands Holding BV are treated by the IRS as if they were divisions of Google Holdings – thanks to the U.S. check-the-box rules. In effect, Google generates “stateless income.”<sup>33</sup>

Dutch affiliate Google Netherlands Holding BV last month published accounts that made clear Google, Inc.<sup>34</sup> channeled more than 10 billion euros to its Bermuda-based Google Ireland Holdings, in 2014.

### 3.3.2. Remuneration for intangible assets held offshore

Prominent individuals enjoying media attention may derive significant income from the licensing or sale of imaging rights, advertising, performance rights, contract signing fees etc. that are preferably owned by offshore entities.

The other type of intangible assets that features extensively in such schemes is technology and patentable intellectual property. The focus on economic substance in order to claim tax preferential treatment is possibly nowhere stronger than in R&D activities. Most national tax systems already allow the costs of research and development to offset tax liabilities, without having to take recourse to patent boxes and the like. The European Commission<sup>35</sup> finds that “patent boxes seem more likely to relocate corporate income than to stimulate innovation. Unfortunately, tax planning and tax competition also complicate the possibilities for evaluation of the effectiveness of patent boxes with respect to innovation.”

### 3.3.3. Risk transfer schemes – Cost contribution arrangements

The OECD’s Transfer Pricing Guidelines<sup>36</sup> define a Cost Contribution Arrangement (CCA) as “a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights [...] For the conditions of a CCA to satisfy the arm’s length principle, a participant’s contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement.”

The guidelines include the requirement to take into account the risk assumed by the parties to the transaction. The reason is that in the open market more risk usually calls for an increase in expected return depending on the degree to which the risk is actually realised. As a consequence, MNC could attempt to shift profit to low-tax-rate jurisdictions by shifting risk accordingly, as the OECD readily recognises. Such a scheme is attractive because the risk transfer has no further bearing on the MNC group as a whole.

<sup>33</sup> Edward Kleinbard (2011), *Stateless Income*, Florida Tax Review 11, pp. 699.

<sup>34</sup> Reuters (2016), *Google accounts show 11 billion euros moved via low tax 'Dutch sandwich' in 2014*, February 19.

<sup>35</sup> European Commission Taxation Paper (2014), *A study on R&D Tax Incentives*, Working Paper No. 52.

<sup>36</sup> OECD (2010), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

#### 3.3.4. Holding accounts in « insurance wrappers »

Insurance wrappers are accounts held in the name of an insurance company but funded with assets of the policy holder. They allow to conceal the identity of the ultimate beneficial owner of the managed assets. In the wake of the UBS case, insurance wrappers were actively marketed to Swiss banks as a means of disguising the identity of United States taxpayer undeclared assets.

More structurally, corporations may be allowed to create “captive” insurance companies. The insured can then claim deductions for premiums paid to the captive insurance company to insure the owner against, sometimes implausible, risks at largely self-determined premiums. As long as the captive insurer is small enough, only the investment income is taxable.

#### 3.3.5. Excess-profit rulings

Excess-profit rulings exempt a portion of profits – typically earned on intragroup transactions – to the extent that they are deemed to exceed a normal arm’s length profit. The European Commission<sup>37</sup> has recently ruled that such excess-profit regimes are a form of state aid.

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<sup>37</sup> [http://europa.eu/rapid/press-release\\_IP-16-42\\_en.htm](http://europa.eu/rapid/press-release_IP-16-42_en.htm).

## 4. QUALIFICATION OF CAPITAL FLOWS

### 4.1. The corporation as a cash flow stream

From a legal perspective, the corporation is considered a collection of contracts with stakeholders, resulting in the ownership or use of various assets and the (limited) commitment to honour various liabilities. The view from finance sees the corporation as a stream of cash flowing into or out of the entity. For a financial risk manager or analyst, the future cash flows are potential cash flows, depending on whether an exposure will be realised or not.

A corporate asset represents a subset of such cash flows typically consisting of a large initial cash outflow to obtain the right to use the asset followed by an uncertain stream of cash inflows resulting from operating the asset. A corporate liability reverses in- and outflows : a source of funds comes with the obligation to reimburse the capital provider with cash flows generated in the future. The total accumulated net cash flows must be non-negative for the corporation to be in going concern.

What is important to tax planning, is that corporate finance allows for a considerable degree of freedom in how to account for individual cash flows. The *timing* of when to recognise each cash flow as an income or expense can be varied. The *quality* of cash flows is furthermore not uniform. And finally, the category or *identity* with which cash flows are designated is somewhat fungible.

The accounting game consists of portraying the corporation's financial state by matching revenues and expenses, and gains and losses to the calendar period in which they arise, rather than to the period in which the cash flows actually take place. Depreciation and amortisation for example distribute the large cash outlay to purchase an asset over the useful life of that asset. Only slightly exaggerating, income and costs can be shifted backward or forward through time to the extent that « profit or loss » is only an opinion rather than a fact.

Investment banking (including private banking for HNW) makes use of financial engineering to reassemble corporate or sovereign cash flows in the form of securities – total return swaps, collateralised debt obligations, put and call options – that cater to their clients' every need. The central identity goes by the name of « put-call parity », establishing an equivalence between a specific combination of equity, debt and put and call options on the underlying shares. To the extent that fiscal treatment does distinguish among these perfect finance substitutes, a tax arbitrage opportunity opens up. Hybrid securities are engineered with just enough characteristics to qualify as debt for (favourable) tax purposes, but incorporating the appropriate derivatives to function as equity from an economic point of view.

As a result, tax considerations loom large in many structured products and in the manner in which mergers and acquisitions occur. In an unfortunate similarity with the arguably somewhat skewed portrayal of accounting above, the name with which cash flows occurring in these structures are designated by fiscal authorities can be ambiguous. If taxable income passes from one jurisdiction to another, and both treat the economically equivalent cash flow in a different manner, the opportunity for taxpayers to exploit mismatches arises.

Generally speaking, there are three « sources » of funds for corporations : next to equity and debt, internally generated intangible assets such as trademarks can appear to create value out of thin air. Aggressive tax planning in many cases involves transforming dividends, interest or royalties in their tax-efficient form, taking into account how the different fiscal revenue bodies formally designate the income or expense.

When corporate cash flows are used to reimburse capital providers, one of the defining issues in taxation shows up: how legislators come to terms with the threat of double taxation. The absence of withholding tax on dividends generally serves to prevent this double taxation. But instead of being subject to double taxation, dividend payments can be engineered in such a manner that double *non*-taxation applies. The 2014 amendment of the Parent/Subsidiary Directive was passed to ensure that dividends received must be taxed if they are deductible on the subsidiary's tax return in another Member State. Aggressive tax planning schemes may attempt to circumvent the revised directive by locating outside the European Union and still enjoy double non-taxation.

Tax-deductible interest payments can be artificially blown up to erode the tax base. Alternatively, interest-free loans could form part of aggressive tax planning schemes where a deduction can be claimed despite the fact that no interest is paid (or accrued). Only an active coordination of the jurisdictions involved can safeguard an appropriate fiscal treatment.

Royalty payments are a cost of doing business. Without proper fiscal coordination however, any favourable treatment of royalties in one country will not necessarily be reflected in the tax return in the other country.

The exploitation of these and other fiscal mismatches ultimately deriving from the qualification of income and expense is a fertile area for unscrupulous financial service providers engineering aggressive tax planning schemes.

## **4.2. Aggressive tax planning schemes – Qualification**

### **4.2.1. Equity/debt hybrid**

The opportunity for aggressive tax planning arises from tax authorities' typical preference for rules attempting to separate prior claims to corporate income – i.e. debt – from residual claims – i.e. equity. The general idea of an equity/debt hybrid construction can be illustrated by reference to the double interest deduction scheme in 2.5.2. The portfolio interest income in the double dip interest deduction scheme may be considered active business income by the tax authorities of Corporation A, allowing it to be received as a tax-exempt dividend.

From a financial engineering perspective however, the dividing line between equity and debt is largely a matter of discretion. The difficulty is exacerbated by tax competition among countries that may lead fiscal authorities to facilitate the use of ambiguous "hybrid" instruments by domestic MNC while at the same discouraging foreign MNC from doing the same. The European Council amended the Parent/Subsidiary Directive in July 2014 to prevent MNC from using hybrid loan arrangements. On 27 January 2015, a further amendment was adopted by which Member States can no longer grant the benefits of the directive when faced with artificial arrangements in general.

### **4.2.2. Tax loss generator scheme<sup>38</sup>**

Although carry-over of losses features in most if not all fiscal systems, tax loss relief regulation differs among countries. Whereas most countries allow "sideways" loss relief, some will limit relief to particular categories of income or profits, or within MNC groups.

In countries where tax losses can offset taxes or otherwise lead to tax savings, a wide range of schemes is engineered by the financial sector, tailored to the taxpayer's specific circumstances, to shelter income from tax. For example, a bank enters into forward

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<sup>38</sup> OECD (2008), *Study into the role of tax intermediaries*.

purchase and option contracts on liquid underlying securities for a brief period of time, often intraday. In the process, tax losses are deliberately generated for the client to claim repayment of income tax. In many cases leverage is provided to maximise the tax savings.

With respect to the financial sector itself, capital adequacy rules and similar regulation makes financial institutions' own tax losses a critical issue as these typically count towards regulatory capital in certain circumstances<sup>39</sup>. It would go beyond the scope of this study to more fully treat these considerations, but regulators and tax authorities ought to be aware of the interdependence of the fiscal and regulatory regime.

#### 4.2.3. Conversion of accumulated losses into cash

A stock-lending arrangement can create taxable interest in a corporate taxpayer's tax return (and an interest deduction in the bank's tax return). Instances have occurred<sup>40</sup> where the bank is remunerated with a share in the client's tax savings.

#### 4.2.4. Call option overlay<sup>41</sup>

12 September 2014, Twitter, Inc. priced two convertible senior notes. At the same time, the corporation entered into privately negotiated transactions to hedge these convertibles with the initial purchasers. These transactions effectively neutralised the original conversion features, rendering the senior notes into synthetic straight debt. In addition, the corporation entered into warrant transactions with the same counterparties designed to reintroduce a strike price that was higher than the initial conversion price.

For tax purposes, the buy-back of the embedded call options in the note hedge transactions and the sale of the call options with a higher exercise price in the warrant transactions are treated as separate transactions. The note hedge transactions valued the conversion option at a specific amount, whereas the higher strike price ensures that Twitter receives a lower premium from the warrant transactions; the combined transaction allows the corporation to receive additional tax benefits.

#### 4.2.5. Shares-as-debt arrangements<sup>42</sup>

Structured finance schemes can disguise interest as capital gains or dividends, in essence stripping shares of their equity-type risks, leaving a return that is to a large extent predictable or fixed. Instead of lending money at interest, a financial institution can for example subscribe to redeemable fixed rate preference shares in the client corporation and receive tax-exempt dividends that are effectively equivalent to interest. Comparable constructs could be set up involving derivatives.

Similarly, a capital gain can be prefabricated through the intermediation of a special purpose vehicle (SPV) that enters into transactions with a financial institution. The transactions are structured in such manner that the value of the shares of the SPV owned by the corporation increases in a controlled fashion. It would typically be the case that the corporation would have accumulated capital losses to offset the gain.

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<sup>39</sup> OECD (2010), *Addressing tax risks involving bank losses*.

<sup>40</sup> OECD (2008), *Study into the role of tax intermediaries*.

<sup>41</sup> Matt Levine (2014), *Twitter Is Junk. Why Are You Surprised?*, Bloomberg View, November 31.

<sup>42</sup> HM Revenue & Customs, *Corporate Finance Manual 45010 - Deemed loan relationships: shares with guaranteed returns, sqq.* and *45510 - Deemed loan relationships: shares accounted for as liabilities, sqq.*

#### 4.2.6. Collateralised loan/sale & repurchase hybrid<sup>43</sup>

A repo transaction may be considered as a collateralised loan in one jurisdiction, and a sale and repurchase of shares in the other. Consequently, the proceeds from the final sale of the securities underlying the repo transaction are treated as tax-deductible interest and potentially tax-free capital gains respectively.

#### 4.2.7. Converting ordinary income in capital gains (or other lower-tax-rate receipts)

Because in general, countries tax capital gains more favourably than ordinary income, either by restricting the tax base or applying a lower tax rate, there is a clear incentive to try and convert ordinary income into a capital gain. In particular income derived from performance fees, incentive arrangements in the form of cash bonuses or stock option plans, or erratic but significant remuneration related to specific assignments is liable to aggressive tax planning. Such remuneration packages are extremely common in the financial sector. Operators of hedge funds for example may receive a significant amount of compensation in the form of capital distributions.

Special purpose vehicles such as trusts can be established in low-tax-rate jurisdictions with the stated purpose of benefiting a corporation's employees. The corporation itself may be allowed to claim a tax deduction for a payment to the SPV; the employee will be remunerated by the trust in a tax-minimising way, for example through a lending arrangement or a life insurance policy distribution.

To the extent that employment services are performed internationally, the corporation can bundle all remuneration for such "foreign" services abroad in one country and claim an exemption in the home country. In addition, the employee may seek an exemption in the other country as well. Dual contracts, whether in essence the services rendered are differently or not, may be arranged where domestic services and non-domestic services are compensated differently.

In extremis, an offshore entity can be established that invoices the corporation for services provided. The employee will then be able to draw on the company by way of an offshore bank account, credit or debit card. Alternatively, the employee may own equity in the offshore entity and access the funds by form of a capital gain on the sale of these shares.

Other tax evasion schemes involve a third party that provides highly favourable remuneration or payments in kind to the employee. The employer then compensates the third-party entity for losses incurred.

#### 4.2.8. Corporate event-driven tax planning

Mergers and acquisitions, asset sales, share purchase agreements etc. are frequently structured to include elements of aggressive tax planning from the point of view of the ultimate beneficiary natural persons. The structuring will for example seek to offset capital gains with a (non-economic) loss. Or the gains will be structured to occur in an offshore jurisdiction where the transfer of assets or shares of the corporation is carefully designed not to raise taxation issues (related to transfer pricing guidelines for example or Controlled Foreign Company rules) and the proceeds are ultimately repatriated in a tax-minimising manner.

#### 4.2.9. Allowance for corporate equity abuses

Notional interest represents an imputed interest calculated on the basis of its shareholders' equity that corporations can deduct on their tax return. As we noted earlier, the concept of

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<sup>43</sup> OECD (2009), *Building transparent tax compliance by banks*.



an Allowance for Corporate Equity was introduced in the eighties and has theoretical appeal: it does away with the differential tax treatment of debt and equity<sup>44</sup>.

However, ACE is considered by many authorities as susceptible to being included in aggressive tax planning schemes without sufficient coordination efforts. To counter the scheme, in the event a corporation can claim a tax deduction, such deduction must be reflected in a (taxable) income to the shareholder.

#### 4.2.10. Private annuity trusts

To avoid or defer, sometimes indefinitely, inheritance taxes and/or capital gains tax on the realisation of the value of highly appreciated assets, a private annuity trust is set up to transform the surplus value in an income stream under the form of a (lifetime) annuity.

The transfer of the asset is not taxable in itself. In essence, the trust has purchased the asset from the owner at fair market value. The payment takes the form of an annuity, subject to the form conditions the fiscal authorities impose. These payments are taxable to the extent they represent a share of capital gains, depreciation recapture and ordinary income. The remainder of the assets, and any potential value accrued in excess of the original value is free of inheritance taxes. Whether any of the deferred capital gains taxes are to be paid, depends on whether the owner dies before his or her life expectancy.

Alternatives include the U.S. charitable remainder unitrust.

#### 4.2.11. Charitable remainder unitrust<sup>45</sup>

As with private annuity trusts, charitable remainder unitrusts can be used to « realise » the value in highly appreciated assets and save on income, gift and/or inheritance taxes.

The trust is irrevocable and the *unitrust* aspect refers to the annual (or intra-annual) distribution of a fixed unique percentage (5-50%) of the value of its assets to the settlor of the trust. When the settlor dies, the remainder of the trust's balance is distributed to charity. The donor is entitled to a charitable deduction based on the present value of the remainder. The principal itself is not considered for United States estate tax purposes.

Rather than paying a capital gains tax on a substantial appreciation, payment is spread out over the lifetime of the taxpayer while he or she will receive annuity from the trust for the full present value of the sales proceeds. To mitigate the mortality risk, especially shortly after the unitrust is set up, the unitrust will typically be accompanied by a life insurance policy, with for instance the taxpayer's heirs as beneficiaries.

#### 4.2.12. Disguising dividends as portfolio interest

Since 1984<sup>46</sup> the United States has exempted portfolio interest received by a foreign person from sources within the United States from tax. Portfolio interest includes generally any interest other than interest received by for example a controlled foreign corporation and interest received by a bank on an extension of credit. Importantly, the portfolio interest

<sup>44</sup> For instance, the UK Parliamentary Commission for Banking Standards' report called the government to consider an ACE in particular for banks, where higher levels of equity relative to debt financing could enhance financial stability. Parliamentary Commission for Banking Standards (2013), *Changing banking for good*, Fifth Report, §1026.

<sup>45</sup> Internal Revenue Code §664.

<sup>46</sup> Joint Committee on Taxation (1984), *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84. The idea was that the imposition of a withholding tax on interest paid on debt issued by U.S. persons including the Treasury would make it more difficult for American corporations to raise capital in the Eurobond market (i.e., the market for USD-denominated debt). The same reasoning applies mutatis mutandis to dividend withholding tax and access to global equity capital.

exemption is available only to the extent that the beneficial owner of the registered obligation is not a United States person.

Whereas interest and capital gains are typically not subject to withholding taxes, dividends and non-portfolio interest – as when a subsidiary pays interest to its parent – are. Consequently<sup>47</sup>, if in particular a U.S. person can arrange to receive (dividends disguised as) investment income appearing to be a foreign person, the U.S. investor may be able to evade U.S. income tax. The interest can be (made to appear) derived from a bank deposit or from specific insurance contracts, unless the interest is effectively part of a U.S. trade or business activity.

Similarly, interest on deposits with foreign branches of domestic banks is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).

Gains realised in the sale of property such as investment securities by a foreign entity similarly are exempt from U.S. tax, unless they arise in the conduct of a U.S. trade or business. (An exception are certain gains from contingent payments related to transactions in intangible property.)

The counterintuitive Treasury Regulation that defines swap payments out of the U.S. as foreign source income (2.5.7) applies equally when the payment makes reference, for example, to (U.S.-source) dividends paid on an underlying security. By going “long” a swap or call option on U.S. equities with an appreciable dividend yield, the recipient can replicate and enjoy the benefits of the dividends paid without being subject to withholding tax, in contrast with receiving the dividend payment itself.

More generally, so-called “total return swaps” allow for the counterparties to exchange almost any return on any notional investment for a money market payment. In so doing, the investor’s position is equivalent to obtaining exposure for a specified period of time to the investment using funds borrowed from the counterparty.

Note that the dividend payment ought not to be actually paid: derivatives such as forward contracts can be used in which the anticipated payments are reflected in the pricing of the contract.

A fundamental solution to the problem of avoiding withholding tax by categorising income in one category rather than another would be to impose a uniform withholding tax on all relevant cross-border payments, including portfolio interest<sup>48</sup>. Of course, even when the withholding tax is imposed, the “foreign” investor may reduce the tax liability by means of the appropriate tax treaty among the relevant jurisdictions, even when none of the jurisdictions coincides with the person’s “natural” domicile or a genuine connection can be verified. Herein lies the origin of most of the “sandwich” schemes that follow from treaty shopping.

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<sup>47</sup> Joint Committee on Taxation (2009), *Tax Compliance and Enforcement Issues With Respect to Offshore Entities and Accounts*, JCX-23-09.

<sup>48</sup> Such a proposal has been advocated by Reuven Avi-Yonah who in general would prefer to tax passive income primarily at source and active income primarily at residence in an internationally coordinated manner.

## 5. IDENTIFYING THE ULTIMATE BENEFICIAL OWNER

### 5.1. Breaking the Swiss bank?

16 October 2015, the United States Internal Revenue Service made public<sup>49</sup> that more than 54,000 U.S. taxpayers had participated in the Offshore Voluntary Disclosure Program and similar procedures to correct prior omissions and meet their federal tax obligations related to undeclared offshore accounts. More than 8 billion USD had been collected from U.S. citizens.

The current automatic third-party account reporting under the Foreign Account Tax Compliance Act (FATCA) and intergovernmental agreements between the U.S. and other jurisdictions combines with the Department of Justice's Swiss Bank Program to continue to uncover past and potential non-compliance. To date, almost eighty financial institutions executed non-prosecution agreements with the U.S. The accompanying statements of facts provide a wealth of detail on specific tax evasion schemes set up on behalf of their clients.

The Swiss Bank Program was initiated when UBS AG came under scrutiny from the United States authorities in 2008<sup>50</sup>. UBS agreed in February 2009 to pay 780 million USD to settle civil and criminal charges by the U.S. government. Since then, Member States such as France and lately Belgium have investigated and/or charged the banking group with money laundering and serious and organised tax fraud<sup>51</sup>. The French investigators estimated undeclared funds belonging to French citizens to amount to between 13 and 23 billion EUR, numbers which UBS has contested. The French government has recouped at least 3 billion EUR through their voluntary disclosure programme.

Other notable settlements with the U.S. authorities include Credit Suisse (2,6 billion USD). The investigation<sup>52</sup> found that Credit Suisse in 2006 had more than 22,000 American clients whose assets' value exceeded 12 billion CHF. Among others, Credit Suisse referred these customers to intermediaries that set up offshore shell corporations in whose name the accounts in Switzerland were held.

A third source of inside knowledge on "illicit best practices" of financial institutions in concealing the identity of the ultimate beneficial owner of bank accounts was provided by HSBC-whistleblower Hervé Falciani to the French authorities. More than 100,000 individuals and legal entities from more than 200 countries are implied, holding more than 100 billion USD – twelve billion of which can be traced to the Chávez government of Venezuela. One data set shows clients and their accounts in the period 1988-2007. Another provides maximum amounts in client accounts at the end of this period. The third data set records notes on clients and conversations with them during 2005.

In addition, a 1,000-page report detailing HSBC Bank USA's efforts to strengthen its internal controls is about to be made public<sup>53</sup>, despite objections by both the bank and the U.S. Department of Justice. And more recently, a Greek list related to HSBC dealings known as the "Lagarde list" has surfaced.

<sup>49</sup> Internal Revenue Service (2015), *Offshore Compliance Programs Generate \$8 Billion; IRS Urges People to Take Advantage of Voluntary Disclosure Programs*, IR-2015-116, October 16.

<sup>50</sup> US Senate (2008), *Tax haven banks and U.S. tax compliance*, Staff Report of the Permanent Subcommittee on Investigations, July.

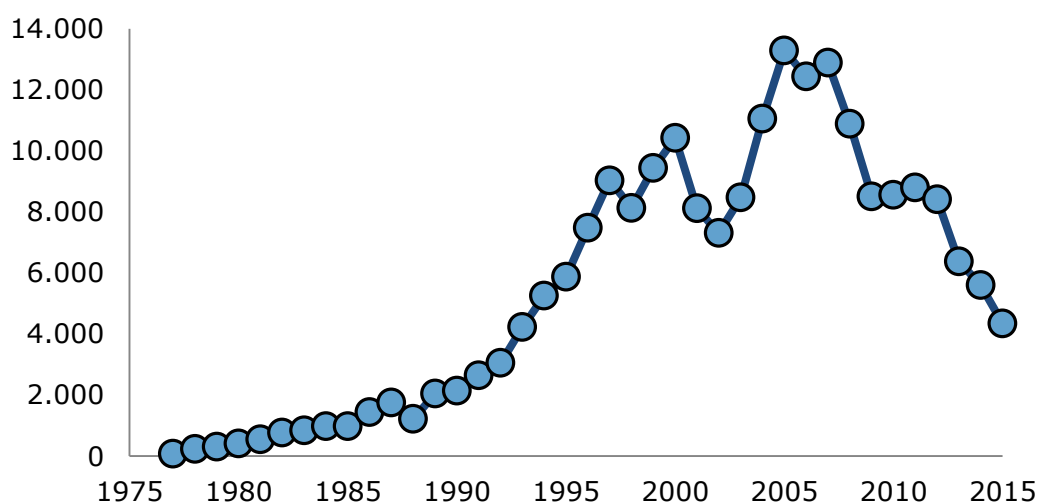
<sup>51</sup> Reuters (2016), *Belgium charges UBS with money laundering, tax fraud*, February 26.

<sup>52</sup> US Senate (2014), *Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts*, Staff Report of the Permanent Subcommittee on Investigations. Washington, DC, February.

<sup>53</sup> Hamish Boland-Rudder (2016), *Report on HSBC's rocky road to reform in US to be made public*, ICIJ, January 31.

At the time of writing, some 11 million files were leaked to the *Süddeutsche Zeitung* concerning the dealings of Panama-based incorporation agent Mossack Fonseca. These “Panama Papers” currently receive quite some media attention, not in the least because among the individuals setting up corporations in Panama and other tax havens that may be used to conceal ultimate beneficial ownership of assets are a number of “politically exposed persons.” Some 210,000 offshore companies in 21 jurisdictions were set up by Mossack Fonseca since 1977.

**Figure 3: The number of offshore companies incorporated by Mossack Fonseca**



**Source:** ICIJ.

The high point was 2005 when 13,287 incorporations took place. Banks were involved in 1,814 of these, more than three times the number two years earlier. The International Consortium of Investigative Journalists relates this surge to the introduction of the Savings Directive<sup>54</sup>. Since then, these activities went in steep decline with only 4,341 companies incorporated in 2015.

## 5.2. Aggressive tax planning schemes – Identity

### 5.2.1. Mirror trades

In 2015 Deutsche Bank came under increased scrutiny of the United States Department of Justice New York State Department of Financial Services for money-laundering through their Moscow office. A “mirror trade” involves buying equities on behalf of Russian clients in rubles, while the same securities are simultaneously sold for comparable amounts in Western currency through a Western office such as London. Allegations are that such transactions were used to circumvent reporting large international movements of money.

The practice to move money out of Russia had been going on at Deutsche Bank for several years and 6 billion USD worth of transactions had been identified. A further 4 billion USD in suspicious transactions were later identified that similarly aided money being channeled out of Russia in contravention of the sanctions against the country.

Deutsche Bank reported that its review had uncovered “certain violations of Deutsche Bank’s policies and deficiencies in Deutsche Bank’s control environment.”<sup>55</sup> Deutsche Bank

<sup>54</sup> ICIJ (2016), *Global Banks Team with Law Firms To Help the Wealthy Hide Assets*, April 4.

<sup>55</sup> Deutsche Bank (2016), *Annual Report 2015*.

notified regulators and law enforcement agencies in the US, the UK, Germany and Russia of its internal probe. The financial institution had earlier been fined by the Russian central bank already for procedural shortcomings – albeit for a nominal amount. The Russian authorities believed the bank was victim of a money-laundering scheme. Nevertheless, Deutsche Bank increased its own litigation reserves by more than one billion potentially to cover fines by Western authorities as well.

### 5.2.2. Passive partnerships

Partnerships are frequently used by pools of high-income earners, in particular in the financial sector, because they are in general transparent for taxation. The idea is to fabricate a single large transaction that generates a significant financial loss. Tax losses generated by such a pooled transaction can then be shared among the partners, together with the expenses implied by setting up the scheme. Fiscal revenue bodies have responded by singling out the “passive” partners, limiting the extent to which they can take into account losses from activities in which he or she is not actively involved, or restricting the tax offset only to other passive income.

### 5.2.3. Incorporation of private activities

Somewhat similarly, entrepreneurs can incorporate private assets and activities in business entities to take advantage of certain beneficial corporate taxation measures.

### 5.2.4. Income or asset diversion

Income or assets can be diverted formally into the hands of family members and other related persons or entities, while the original owner retains control of the income-generating activities or assets. Notwithstanding the high-profile cases that have grabbed worldwide attention, the practice is common on a much more modest scale as well.

### 5.2.5. Inheritance tax evasion

HNW are particularly concerned with inheritance taxes they perceive as too high or unjust, next to the fear of double taxation. Fictitious gifts or transfers can be structured at “off-market” conditions. Assets can be transferred to (or through) offshore entities such as private trusts and foundations. The IKEA case is a well-publicised example where the founder allegedly admitted that the scheme involving a Liechtenstein foundation was intended to escape Swedish inheritance taxes<sup>56</sup>.

### 5.2.6. Undeclared accounts in offshore centres

Numbered or code-name accounts, the use of cover trusts and foundations in tax havens and similar measures to keep the identity of the ultimate beneficial owner concealed from fiscal authorities represent tax evasion in its simplest form. Typically, the financial institutions implicated would, against a fee, hold mail and other correspondence on behalf of the client to minimise any paper trail.

Bank regulation, such as anti-money laundering rules or know-your-client procedures, and legislation across the globe to enforce financial institutions to report the full identity of account holders may gradually prove effective in countering the illicit practice. Company ownership by means of bearer shares avoids having to register the owner’s name. Deficient know-your-customer due diligence further obscures ultimate beneficial ownership. But the crackdown following the UBS investigation apparently led financial institutions to distance themselves as much as possible from these practices. Banks for example transferred

<sup>56</sup> Marc Auerbach (2016), *IKEA: flat pack tax avoidance* – TAAKS AVOYD, Commissioned by the Greens/EFA Group in the European Parliament.

directorship and ownership of offshore companies to individual employees instead of the institutions and their affiliates themselves, or have customers interact with the incorporation and administration agents without intermediation from the bank.

The authorities however should be watchful of the development of innovative schemes to substitute for these straightforward tax evasion strategies. The success in convincing more and more offshore jurisdictions to comply with automatic exchange of information in particular makes upholding secrecy a « best response » for the non-compliant centres.

#### 5.2.7. Hiding assets in bank accounts opened in the name of offshore entities

Flow-through entities are commonly used to conceal the true nature of taxable income or assets and the identity of the ultimate beneficial owner.

An official look into the matter is provided by the Swiss National Bank. The institution records the amounts of the fiduciary deposits held in Switzerland on account of foreigners (cf. supra). The record shows that the proportion of fiduciary deposits belonging to tax havens, or at least to ultimate beneficiaries that have established a sham corporation in these jurisdictions, is growing. Panama, Liechtenstein and the British Virgin Islands feature prominently on the list.

Interestingly, the Swiss National Bank records again illustrate the impact of the adoption of the Savings Directive in the European Union in July 2005. Although the EU directive was successful in discouraging natural persons from owning Swiss accounts, the legislator left a loophole that was quickly seized upon by tax advisors and financial institutions. Because tax is withheld on interest earned by accounts in the name of a European household, sham corporations are an easy way out. Accordingly during 2005, Swiss fiduciary deposits attributed to Europeans declined by 10 percentage points while tax haven fiduciary deposits gained a comparable 8 percentage point market share. As we saw, the “Panama papers” have recently corroborated these findings.

The Swiss Bank Program conducted by the United States Department of Justice and the IRS confirms that all but a few U.S. tax evaders owned accounts through offshore entities incorporated in Panama, the British Virgin Islands, and Hong Kong. The United States IRS summoned HSBC Bank USA and several package-courier services to identify U.S. taxpayers who used the offshore consulting firm Sovereign Management & Legal Ltd to set up anonymous shell companies in Panama and Hong Kong.

Conversely, offshore entities that may be established by domestic taxpayers can open accounts in the taxpayers’ home country which the financial institutions may treat as foreign-owned accounts. In 2006, a United States Subcommittee<sup>57</sup> reported the infamous Wyly case where two brothers operated 58 offshore trusts to hide over 190 million in stock option compensation they had earned from U.S. corporations from the IRS. The financial institutions where some of the U.S. accounts were held knowingly accepted the claim that the ultimate beneficial owner was a foreign accountholders.

Asset managers are known to have used “intermediary” or “transitory” accounts in the name of the external asset manager’s company at a bank to add a layer of concealment when transferring undeclared assets of a client. Typically, the bank would pay the external asset manager a “finder’s fee” and a share in the transaction fees that these accounts generate at the bank.

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<sup>57</sup> US Senate (2006), *Tax haven abuses : The enablers, the tools and secrecy*, Staff Report of the Permanent Subcommittee on Investigations. Washington, DC, August.

#### 5.2.8. Difficult to trace cash withdrawals

Tax evasion by means of undeclared accounts raises the question of how the money in these accounts can be accessed by the accountholder. Financial service providers, including banks and wealth managers, offer liquidity facilities that are difficult to trace. Examples include money loaded onto prepaid debit cards, rechargeable travel cash cards, unreported serial withdrawals in sub-threshold amounts, or the conversion of money into precious metals such as gold and luxury goods such as Swiss watches which could then be remitted to a safe deposit box or freeport.

## 6. RECOMMENDATIONS

Economics, and the design of optimal mechanisms such as taxation, are a matter of incentives and information. Fiscal authorities must gain a clear understanding of the demand and supply drivers for aggressive tax planning schemes and the unintended incentives tax legislation provides to designers and operators of such schemes. As is clear from the schemes discussed herein and those covered in the literature<sup>58</sup>, MNC and HNW aggressive tax planning schemes are only viable where the jurisdictions concerned suffer from inconsistency of definitions and consequently tax treatment, and from a lack of coordinated information exchange that impairs a comprehensive understanding of the workings of international aggressive tax planning schemes.

### 6.1. Understanding the incentives for aggressive tax planning

#### 6.1.1. Drivers of demand for aggressive tax planning

- **Risk aversion and risk tolerance** vary among and within MNC and HNW, and may in particular differ from their advisors in the financial sector. Identifying the characteristics of these behavioural segments will allow a more targeted approach to designing pro-active anti-avoidance measures and to detect and remedy evasion in a more efficient and effective manner;
- With those taxpayers identified as susceptible to aggressive tax planning, fiscal revenue bodies must build a relationship that puts **a premium on transparency and (early legal) security** of legitimate tax planning rather than non-cooperation and non-disclosure in a conflict model. In order to provide clarity about the boundary between acceptable planning and aggressive avoidance or evasion, legislation must incline towards being **principles-based rather than rules-based**.
- The **degree of financial sophistication** of HNW and MNC will in general be lower than the expertise of their financial advisors, and the relationship between fiscal revenue bodies and taxpayers, who should be reminded that they remain ultimately responsible for their tax return, can accordingly be different(iated) from the relationship between fiscal revenue bodies and financial advisors. Ease of “doing business” may for example rank much higher with taxpayers than with their financial advisors. On the other hand, fiscal revenue bodies must be provided with the resources to confidently challenge aggressive tax planning advice.
- Taxation ought not to be entirely separated from other dealings between governments and citizens. It forms an inherent part of the endeavour to create a **more fair and equitable society**. Public procurement or state aid in the form of tax credits or innovation incentives may include terms and conditions that refer to tax avoidance (evasion).
- Demand (as well as supply) for aggressive tax planning can be reduced by building a **stable and predictable fiscal environment** grounded on sound principles rather than complex rules. To the extent that fiscal competition among Member States is deemed beneficial, the European Union must ensure that such competition is transparent and more inclined towards competing on tax rates than on tax base.

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<sup>58</sup> For further references, see the final package in the OECD/G20 Base Erosion and Profit Shifting project : OECD (2015), *Reforms to the international tax system for curbing avoidance by multinational enterprises*, October 5, or the European Commission Taxation Paper (2015), *Study on Structures of Aggressive Tax Planning and Indicators*, Working paper No. 61, the various reports of the U.S. Senate Permanent Subcommittee on Investigations, and the website of the United States Department of Justice Offshore Compliance Initiative and Swiss Bank Program.



- Tax **rulings should be restored to their original intent**, i.e. to (passively) clarify the application and interpretation of existing tax legislation to avoid *ex post* differences of opinion between taxpayer and revenue body, rather than continue to form a discretionary tool to obtain preferential comfort around aggressive tax planning, in particular related to transfer pricing.

#### 6.1.2. Drivers of supply of aggressive tax planning

- Regulators and legislators should be mindful of the positioning of individual and package-deal financial service providers in the market for aggressive tax planning. The (evolution of the) **financial advisory market structure** holds important clues to preview, identify, monitor and if necessary react to the trends and undercurrents of aggressive tax planning.
- **Fees contingent on tax savings must be disallowed.**
- Legislators must deter the implementation and promotion<sup>59</sup> of aggressive tax planning schemes by providing for an **enforceable Code of Conduct** and professional and/or criminal sanctions, rather than relying on self-regulation. In addition, legislators must encourage or require individual members of the financial sector such as bank officers, accountants or corporate finance advisors to **actively report activities** that may be part of aggressive tax planning through such measures as the Convention on Administrative Assistance in Tax Matters and the 2014 amendments to certain EU directives.
- The ongoing strengthening of disclosure regimes must allow fiscal revenue bodies to **publicise disclosed aggressive tax planning schemes** and the promoters or implementors involved.
- Legislation invariably calls forth opportunities to be circumvented or interpreted in a manner that is unintended or unexpected by the legislator. To enhance resilience to avoidance and evasion, **general or specific anti-abuse rules** must accompany any legislation and enforcement of such rules must form an integral part of legislation. Similarly, legislators can **encourage stress-testing** the envisaged legislation, preferably before it is enacted.
- Legislators must continue to coordinate their efforts to fight tax evasion. In particular the European Union must seek to find common ground between for example the European Parliament's resolution<sup>60</sup> of 21 May 2013 and the Anti-Tax Avoidance Package recently introduced by the Commission, the proposed Stop Tax Haven Abuse Act<sup>61</sup> in the United States and similar **initiatives within but also outside the OECD or G20 fora.**
- Bank and insurance regulators should be aware of **the dependency of capital requirements and tax strategies of financial institutions.** Principles-based regulation and macroprudential supervision is conditional on understanding the business rationale of operating, investing and financing decisions. The nature of banking in particular and the financial sector in general complicates the identification of fiscal residence or even nationality of financial institutions, only compounding these issues. **Information exchanged with fiscal authorities on the one hand,**

<sup>59</sup> Public Accounts Committee (2015), *Tax avoidance: the role of large accountancy firms (follow-up)*, February 6.

<sup>60</sup> European Parliament resolution of 21 May 2013 on Fight against Tax Fraud, Tax Evasion and Tax Havens.

<sup>61</sup> See Jane G. Gravelle (2015), *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, January 15.

**and financial supervisors and regulators on the other hand, must be integrated.**

- The presence of tax advisors and other financial sector actors in advisory bodies such as the EU Platform for Tax Good Governance raises concerns over **conflicts of interest** that must be publicly and transparently managed.

## **6.2. Coordinating information and intelligence on aggressive tax planning**

- The structural concepts of international taxation, such as source-based, residence-based and destination-based taxation, substance over form, permanent establishment and tax residence, arm's length pricing and formulary apportionment, comparability analysis and risk transfer in transfer pricing, the extent of qualification of interest, dividend and royalty payments, the dividing line between equity and debt financing, controlled foreign company rules, ultimate beneficial ownership etcetera must be **unambiguously and consistently defined** by the Member States in the European Union, their trade and investment partners in the OECD and the G20, and the offshore centres with which its citizens and corporations interact.
- **Treaty shopping must be discouraged** through (domestic) anti-avoidance rules and provisions in double tax treaties such as limitation of benefits, and the establishment of a wide-ranging multilateral framework. At the same time, initiatives such as the OECD's BEPS or the Commission's ATAP must provide **safeguards against double taxation and against erosion of the Union's competitive position.**
- The analysis of aggressive tax planning shows that such schemes can be countered only when **policies and actions are coordinated among** each of the jurisdictions involved – **host countries, conduit or transit jurisdictions in which capital flows through and destination countries**, in particular when some of these countries are not Member States. Country-by-country reporting cannot substitute for an integral understanding of the full scheme. "Productivity" or "return on investment" calculations involving isolated entities' assets, equity or workforce at best paint a partial picture. Information should be exchanged multilaterally, timely and comprehensively and any action should be coordinated among all involved countries.
- Authorities must be aware that, in particular with respect to developing nations, offshore jurisdictions form an inherent part of how international financing and investment flows are routed. The potential **impact** of fiscal legislation or anti-tax avoidance actions **on global investment and finance** must therefore be assessed and taken into account.
- Finally, the objective of global coordination efforts must be the establishment of a **worldwide comprehensive registry** of ultimate beneficial ownership of financial holdings. In the absence of a truly global registry, such a registry may be constituted by piecing together unilaterally composed individual country registries.

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## **ANNEX**

### **Author short biography**

Karel Volckaert works since 2014 as an independent consultant in investment strategy and risk management. Karel graduated as a civil engineer in theoretical physics and control theory from Universiteit Gent (Belgium) summa cum laude. He has earned the charter of Financial Risk Manager (GARP) and Chartered Financial Analyst (CFA Institute). Together with Ivan Van de Cloot, he is the author of "Taxshift" (LannooCampus, 2015).

In 2001, he joined a Belgian investment bank now part of ABN-AMRO as a quantitative strategist. There he co-managed the institutional fixed income portfolios and the bank's long-short equity funds. From 2004, he was senior consultant and director of research at an independent valuation specialist with a focus on the valuation of complex financial instruments and intangible assets in the context of asset management, risk hedging strategies and corporate M&A transactions. Advisory clients included international financial institutions, Big Four auditors and high net worth families. In 2012, Karel joined a Belgian wealth manager where he was responsible for portfolio strategy and risk analysis. He was a member of the Strategic Committee and the Investment Committee, and co-manager of the Emerging Markets funds.

**NOTES**



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