Committee/Council: Economic and Social Council

Issue: Tax havens used by MNCs

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Introduction

Multinational corporations have become a key element of today's global economy, as globalization has enabled cross-border activity, and the frequent transfer of intangible assets and enormous amounts of money at the push of a button worldwide. One experiences this in their everyday life by consuming products imported from "somewhere", made "somewhere else" and owned by a company founded in yet another country. But our society also experiences the benefits of the public expenditures that the state offers, drawing money from taxes that every entity and corporation has to pay. While multinational corporations gain enormous profit by expanding their assets and activities to many nations, creating subsidiary companies, and coordinating the use of the labour force and the natural resources of other nations from a central headquarters somewhere in their nation of origin, governments face enormous trouble taxing MNCs due to this flexibility of capital transfers. It is, therefore, difficult to draw up a universally binding legal framework encompassing and synchronising worldwide tax legislation, let alone assess the exact costs of possible tax avoidance by MNCs for each society, when trillions of dollars are at stake. However, we can examine the most common and well-known means of tax avoidance for MNCs today: tax havens.

Definition of Key-Terms

Tax havens: Nations or jurisdictions attractive to foreign investors such as MNCs due to the fact that in exchange for a fee they offer minimal or no taxation, light or moderate financial regulations and different degrees of bank secrecy.

Multinational Corporation (MNC): A corporation that has income-gathering assets and liabilities in one or more countries other than its home country, which means that it engages in international production. It must be noted that there is a difference between firms that simply engage in overseas trade or are contractors for foreign firms and Multinational Corporations, although it is quite indiscernible: MNCs are different from the aforementioned firms because a relatively big percentage of their profits and assets are accounted for by overseas operations and their many

subsidiaries around the globe, whereas simple overseas trade only accounts for a small percentage of the firms' total profits which are mainly gained onshore.

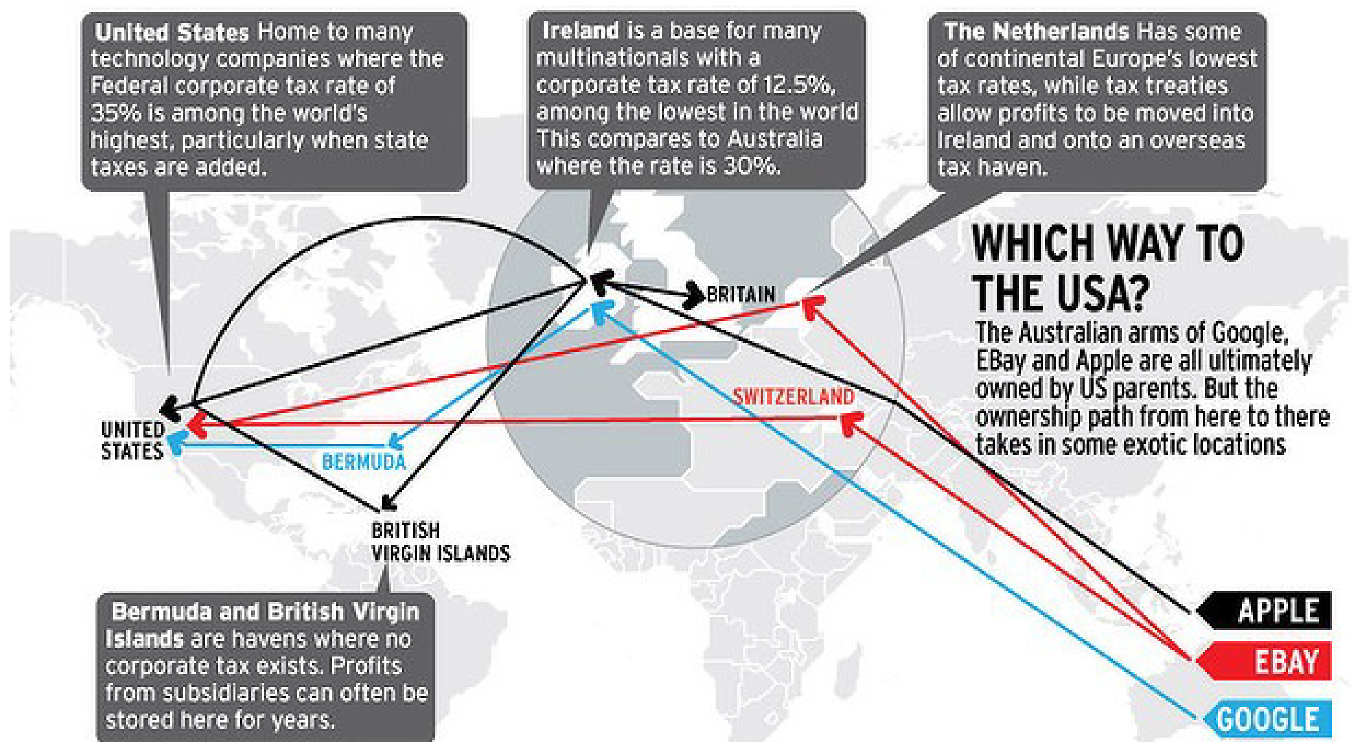
Tax: a financial charge that an individual or legal entity is obliged to pay to a state for the funding of public expenditures.

Tax avoidance: The legal reduction of tax payments (not to be confused with tax evasion, which involves the illegal reduction of tax payments).

Bank secrecy: In jurisdictions where the principle of bank secrecy applies, banks are legally prevented from providing authorities with personal or account information about their clients.

Double taxation: Double taxation occurs when a corporation has to pay taxes for an income that has already been taxed, either in the same or in another country, e.g. when the income of companies is taxed as corporate income when earned, and then taxed, again, when distributed to stockholders as personal income.

Interest: A fee paid on a regular basis at a certain rate for money (or other assets) that has been lent



Background Information

<u>The transport of money offshore</u>

Due to the existence of tax havens, MNCs have come up with plenty of schemes to creatively manipulate tax legislation loopholes for the sake of tax avoidance. While these are most often within the boundaries of the law, it is widely believed that they cross ethic borders. However, many corporations view these practices as a way to boost corporate income and possibly increase share price. An example is the defense that *Google* Chairman Eric Schmidt presented for *Google*'s tax arrangements involving the transfer of "$9.8bn […]of revenues from international subsidiaries into Bermuda" (2011). He stated, "I am very proud of the structure that we set up. We did it based on the incentives that the governments offered us to operate." However, other companies such as *Starbucks* feel that implementing these practices to a great extent will directly harm their reputation and decrease their customers. Some methods MNCs use to move profits to tax havens are listed below:

Aggressive transfer pricing or transfer mispricing: Setting up a company or a subsidiary in a tax haven and making payments to that company either for services that do not exist or for intra-firm purchases whose price is greatly exaggerated. When this occurs, many companies shift a great part of their profit to low or no-tax jurisdictions and at the same time their losses and deductions to higher tax jurisdictions. It has been estimated by the Organization for Economic Cooperation and Development (OECD) that about 1/3 of global trade is trade between such "related parties".

Thin capitalization: Companies with shareholders (also known as "Anonymous Companies"), which comprise the majority of MNCs, are commonly financed in two ways: by borrowing money (debt) and by increasing capital for the issuance of stocks (equity). Many companies carefully structure their capital to legally lower the amount of profit that must be reported for taxes. They achieve this by manipulating the fact that tax laws usually allow a deduction of tax for interest paid for a corporation's debt, but not for payment of equity. So, they choose to be more indebted. They borrow money from their affiliates in low-tax jurisdictions, the tax for the interest of this debt is deducted according to tax laws, and then they pay the debt and the interest back to their affiliates in the tax havens, thus lowering their tax burden without losing any money.

Hiding income: Income is received in a non-traceable form such as cash and then deposited in an account in a tax haven but it is not declared to the home country before that. Alternatively, the payer is instructed to directly deposit the payment in a tax haven bank account.

Tax haven supporters claim that tax havens increase the competition and the productivity in the market by enabling MNCs to invest more money and that many high-tax jurisdiction governments in fact support this, but not openly, although it is hard to prove the latter.

The effects of the use of tax havens

Developed nations

Thousands of banks and more than 2 million companies have capital located in tax havens. It is roughly estimated that this wealth reaches $20 trillion, even though it is difficult to be exact due to the characteristic secrecy that hangs over tax havens (the Economist, 2013). After studying 60 large U.S companies, the *Wall Street Journal* found that in 2012 they had deposited $166 billion in tax havens, thus avoiding paying taxes to the U.S. for over 40% of their profits. However, since most developed nations with MNCs that have money stashed away in tax havens have enormous national debt and at the same time a GDP that suffices for paying this debt off, this amount of money would make no big change to the fact that they are debtors. It would also not lead to radical changes in the lives of the citizens. It is more of a moral question and a question concerning the amount of money that could be used for public expenditures if taxes for those profits were paid. Tax havens' critics point out that corporations benefit from and develop because of each developed nation's domestic stability, security and productivity, while at the same time avoiding taxes that support domestic stability, security and productivity, leaving them to the far less rich citizens and small companies. Furthermore, governments have protested that they are continuously pressured to lower taxes on capital and business due to tax competition among states: In the U.S., tax avoidance by MNCs has led to historically low levels of corporate income tax revenue as a percentage of all federal revenue(in 1952 it constituted 32.1% of all federal revenue, in 2009 only 8.9%).

Developing nations

While it might be true that for "economy giants" such as the U.S., Russia and Japan and even for other developed states, obtaining the full amount of taxes that corresponds to the total profit of MNCs won't cause fundamental changes in society, this cannot be said for developing states. This money could be used by the governments of developing states for vital infrastructure, much-needed welfare programs and the improvement of the educational system. But how much money that ought to be in the public coffers of those countries is actually in tax havens? And where does it come from? Many countries with immensely wealthy natural resources such as DR Congo, Zambia, Sierra Leone and Uganda also score very high on lists of the

world's least developed nations. This is largely attributed to MNCs that use Foreign Direct Investment (FDI) to exploit the natural resources of those countries through the placement of affiliate companies in them, since the governments of developing nations often lack the expertise and technology to do this by themselves. While this might provide more job positions and seem like a good way to boost the country's economy through more taxes paid by foreign factors and not the citizens, it often has the exact opposite effect: MNCs use the methods mentioned previously to transfer their profit to tax havens, thus depleting the natural resources of the country, but providing the country with minimal financial benefits, and eroding the tax base. A typical example is that of Zambia, where the government reports losing an estimated two billion a year-15% of Gross Domestic Product-to tax avoiding corporations that operate copper mines in the country(IMF 2013 estimates). Another deceitful problem is that of developing nations that decide to adopt tax haven policies in order to boost the economy. While it has been documented that business and tourism in tax havens develop, those types of activity tend to exclude local populations. FDI brings its own workforce and often raises property values and prices to levels that the locals cannot afford. Therefore, this does not largely benefit the less-economically-developed local economy, as the money circulates between well-to-do individuals and foreign investors such as MNCs.

What's in it for the tax havens?

Those tax havens that have been established in well-governed, economically stable countries or regions experience higher capital inflows, and therefore economic growth, but also increased fiscal revenues and new job opportunities that increase employment for local labor. There are also opportunities for investment in tourism and the improvement of infrastructure.

Major Countries and Organizations Involved

The G20

The G20 is a forum comprised of the governments and central bank governors of 20 of the world's largest developed and emerging economies. During the global financial crisis of 2008-9, the G20 took a global initiative to pressure the largest, most successful and well known tax havens such as Switzerland to end the era of banking secrecy by signing bilateral transparency agreements under the threat of economic sanctions. This expressed the will of the world's top economies to support policymakers in the invigoration of stricter international financial regulations.

The Organization for Economic Cooperation and Development (OECD)

The OECD is an organization comprised of 34 member states with the aim of promoting policies to improve the economic and social welfare of the global community. The OECD has actively engaged in the issue of tax havens by creating the Global Forum on Transparency and Exchange of Information for Tax Purposes in 2000 to address this issue and request transparency in the exchange of tax information between countries. As a response to the call of the G20 to invigorate the establishment of the necessary standards, the Global Forum was restructured in 2009 and it now has 126 members. Its platform is now also open to non-members and it makes continuous efforts to monitor and ensure the implementation of the transparency standards of its members.

Tax Justice Network (TJN)

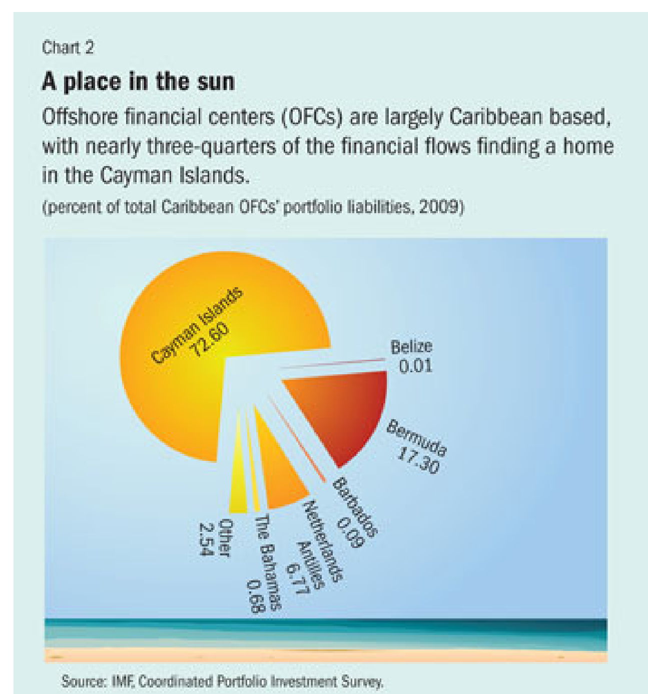
Tax havens are a particular focus of the work of TJN, which is an international independent organization conducting research, advocating and publishing in the field of international tax and financial regulations. The Tax Justice Network is based in the UK and not aligned to any political party, and it researches the repercussions of tax avoidance, tax evasion and tax havens. In 2013, it launched the Financial Secrecy Index, where jurisdictions are ranked based on their secrecy and the capacity of their activities. It is often strongly positioned against tax havens.

Global Financial Integrity

Global Financial Integrity is a non-profit organization research and advisory organization based in Washington, DC, that makes efforts to promote global financial development and stability through extensive analyses on illicit capital flight, policy suggestions for developing countries and the promotion of transparency in financial transfers.

The Caribbean

It was estimated by the U.S. Department of Treasury that almost $2trillion in US debt was stored in Caribbean Banking Centers such as the Bahamas, Cayman Islands, Panama, Netherlands Antilles and Bermuda. As shown on the graph, the Cayman Islands hold the majority of foreign capital in the Caribbean, as $1.4trillion of the above debt was held in them alone. In recent years, the Cayman Islands have made steps towards decreasing banking secrecy and requesting that banks cooperate with foreign



investigators, but corporate tax rates remain at zero. It is also important to note that the Cayman Islands qualify as a British Overseas Territory.

Major tax havens

Apart from the Caribbean islands, the corporate income tax rates of which are in many cases at 0%, European countries with comparatively low corporate income tax rates and a fading tradition of banking secrecy are also thought to be tax havens. Switzerland, Luxembourg, and Ireland are characteristic examples of such. In the east, the Hong Kong Special Administrative Region of the People's Republic of China is also famous for its low corporate taxes and its dominant role in world trade. However, it is noteworthy that the taxation system of Hong Kong is not the same as that of China.

Timeline of Events

Date	**Description of event**
2000	Creation of the Global Forum on Transparency and Exchange of Information for Tax Purposes.
2005	Final communiqué of the U.N. World Summit in New York “resolved to support efforts to reduce capital flight.”
2013	Declaration on Automatic Exchange of Information issued and signed by all 34 OECD members, as well as some non-members

Relevant UN Treaties, Resolutions and Events

United Nations Model Double Taxation Convention between Developed and Developing Countries

While the main topic of this convention is the international effort to eliminate double taxation, some articles include limitations and definitions on the topic of corporate income taxation and aggressive transfer pricing. (Here is the link to the full text of the convention:

http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf)

United Nations Practical Manual on Transfer Pricing for Developing Countries

This manual created by the United Nations Committee of Experts on International Cooperation in Tax Matters (which is a subsidiary body of the ECOSOC) contains practical guidelines for policymakers so that they can implement the ''arm's length'' principle efficiently both in developing and developed states.

United Nations Conference on Trade and Development (UNCTAD)

UNCTAD is the UN's pivotal point for issues concerning worldwide trade and development such as sustainable development, finance and investment. It makes efforts to reach globally acceptable solutions in areas of national and international policymaking that is designed to promote development and ensure a drastic combating of the challenges ensued from globalization, such as the ones mentioned before.

Previous Attempts to solve the Issue

The issue of tax havens has gained more and more attention since 2000, and the global economic crisis of 2008-2009 caused it to be elevated to the top of priority issue lists of organizations and forums such as the G20 and the OECD. The first action taken by the Global Forum in 2009 was "naming and shaming", meaning the classification of countries based on criteria that showed whether or not they were complying with international tax standards. Jurisdictions were classified into three groups:

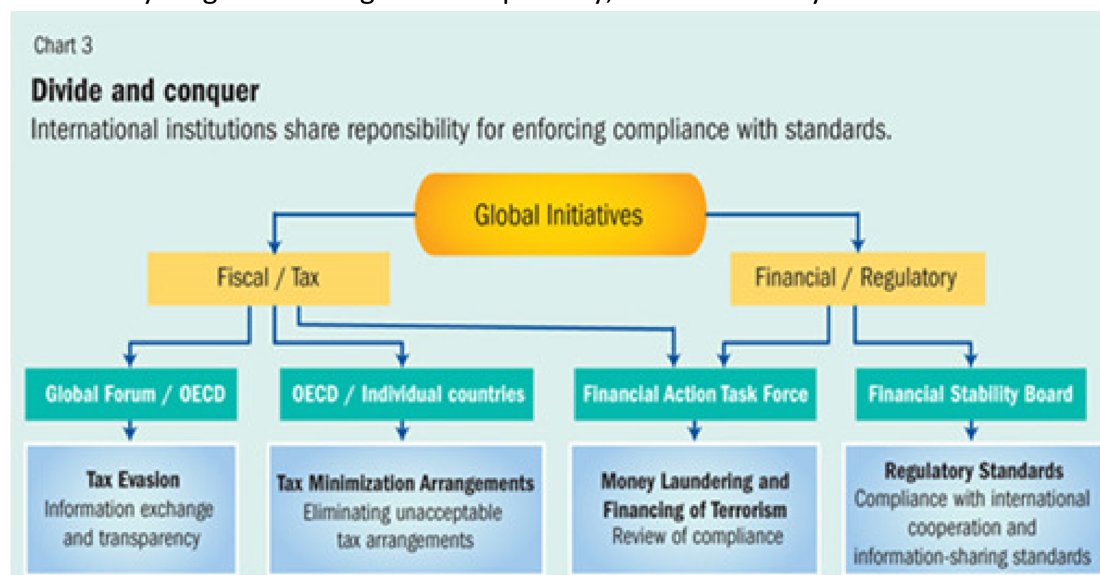
- The white list: Jurisdictions that have committed to internationally agreed tax standards and implemented them

- The grey list: jurisdictions that have committed to internationally agreed tax standards, but haven't fully implemented them

- The black list: Jurisdictions that have not even committed to internationally agreed tax standards

However, there are almost no countries in the black list, seeing as any country could be moved to the grey list by simply providing enough evidence to assure the OECD that a jurisdiction would commit to these standards. To move to the white list, a jurisdiction had only to sign at least 12 bilateral agreements meeting the standard. The result was that many grey-listed jurisdictions signed agreements among themselves and passed into the white list, disappearing from the map of suspicion without changing anything. Another step was the aforementioned Financial Secrecy Index provided by the Tax Justice Network. A more recent step towards transparency was made by the G20 in 2013, in the form of the declaration on Automatic Exchange of Information in Tax Matters (AEoI), which was issued and signed by all 34 members

of the OECD as well as some non-members[1]. The G20 declared that AEoI is "the new global standard." However, there was lack of inclusion of developing countries and premature inclusion of countries known to be tax havens, which is considered to be a risk for the system. Furthermore, none of the aforementioned attempts are specifically aimed at the issue of tax avoidance by MNCs with the use of tax havens, but merely at guaranteeing tax transparency, which can only decrease tax evasion.



As illustrated in the figure above, international organizations have undertaken responsibility for different branches of the issue, in order to tackle it more effectively, since it is very complex and requires a step-by-step reviewing of the processes, careful inspection of many aspects and the guarantee of transparency. The OECD and its Global Forum have specialized in ensuring that the fiscal policies of separate nations include transparency measures and do not leave much room for companies to implement practices, such as aggressive transfer pricing undisturbed Also, it encourages nations to eliminate unacceptable tax arrangements and sign bilateral agreements that include fairer taxation of corporations and individuals. The Financial Stability Board (FSB) checks up on the regulatory aspect, making sure that everyone abides by internationally-agreed transparency standards and the Financial Action Task force is more concerned with the illegal money laundering that individuals or controversial -and possibly dangerous- organizations might exercise. As a matter of fact, it does not fall under the issue of tax havens used by MNCs. No actions have been taken by the UN, in order to specifically to solve this issue since it falls clearly under the jurisdiction of each separate nation. However, many developed nations have implemented anti-avoidance legislations against aggressive transfer pricing and thin capitalization. Measures against the latter include legal regulations about the debt/equity ratio that anonymous corporations are obliged to

[1] Argentina, Brazil, China, Colombia, Costa Rica, India, Indonesia, Latvia, Lithuania, Malaysia, Saudi Arabia, Singapore, South Africa

have, so that they are not too indebted and tax deduction is minimal. Moreover, Article 9 of the OECD's Model Tax Convention has introduced the "arm's length principle" in an attempt to limit aggressive transfer pricing. According to Article 9, prices for transfer of assets or liabilities between two related corporations should be the same as they would be in the case of a transfer between two unrelated parties. This, of course, still allows room for corporations to claim that the actual price of the product is what they are transferring it for.

Possible Solutions

This is a very controversial issue, seeing that the corporations are multinational and governments cannot directly interfere and compel them to pay corporate taxes in their country of origin, as they could with the case of individual citizens. However, many attempts have been made for transparency and experts have suggested certain legislative measures each nation can take. The ECOSOC must lay out suggestions for legislations that each separate nation can implement in order to set boundaries to tax avoidance, such as the ones mentioned before about thin capitalization (the debt/equity ratio) and aggressive tax planning. Furthermore, the UN must take actions such as the ones implemented by the OECD, seeing as it has many more member states and is extremely influential. The creation of a resolution similar to the OECD Model Tax Convention (link here: http://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf) will be highly effective, as measures such as the ''arm's length'' principle will be official and there will be more pressure on nations to implement it.
Another significant improvement would be UN-funded and -conducted research by experts in LEDCs, whose natural wealth is being exploited by MNCs, to assess the loss and assist them in the implementation of measures to decrease it (This could be done with the help of the UN Tax Committee and the UNCTAD). A method that has been suggested by the TJN is the creation of an International Financial Reporting Standard that will require country-by-country reporting of the tax MNCs pay and of trading activities. To combat banking secrecy policies that enable tax evasion, many governments have threatened major tax haven governments with economic sanctions in order for them to sign tax transparency contracts (this was the case with e.g. Switzerland, which obliged and signed many tax transparency contracts with the EU, Germany, France and the USA and noticeably limited its banking secrecy policies). However, these measures may destabilize the economies of tax havens. The reduction of financial transactions can occur because of decrease of banking secrecy with the aim of eliminating illicit transfers scaring off legitimate transactions with foreign investors, which can lower tax revenue and employment levels. Furthermore, the repercussions of the "naming and shaming" technique could include a "poor reputation effect" that might spread across many tax havens, including those that are trying to comply with the international standards.

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