

# **Aggressive tax avoidance**

## **A new issue in the context of corporate social responsibility**

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A new issue has emerged in the context of corporate social responsibility, which challenges especially multinationals with complex financial structures. It is tax avoidance – the mostly legal practice of arranging corporate structures and activities to minimise the tax bill. This practice has become more and more aggressive partly due to a tax avoiding industry, that makes big profits by providing their clients with new tax loopholes.

Our NGO, “Aktion Finanzplatz Schweiz”, and the other members of the International Taxjustice Network consider aggressive tax avoidance to be unethical and harmful to nation states and societies. Many individuals and companies tend to think that what is legal is right, but this is not necessarily so in the context of corporate social responsibility.

According to the General Accounting Office nearly two thirds of all US companies paid zero federal taxes between 1996 and 2000. They accomplished this primarily through profit laundering. This is the process of transferring profits from a territory in which they would be taxed to another in which there is either no tax or a lower tax rate.<sup>1</sup> “Massive profit laundering sucks resources out of the United States and other countries, beggars public programs and lays waste the social contract on which taxation must be based: that everyone pays a fair amount”, says Lucy Komisar, a member of the Steering Committee of the Taxjustice Network.

Recent estimates suggest that the US federal authorities lose some 170 billion US\$ annually due to corporate tax avoidance.<sup>2</sup> In 2003 US corporate tax receipts have fallen to just 7 % of overall federal tax revenue, the lowest rate since 1983, the second-lowest since 1934. In the United Kingdom corporate tax receipts have fallen from 28 % of total inland revenue in 1989 to 19 % in 2003.

In the Swiss city of Zürich tax revenue from stock companies has almost remained constant with 30 % of profits before taxes in 2000 and 29 % in 2004. In Zug, the capital of the canton with the lowest Swiss taxes, however tax revenue has fallen from 22 % of profits before taxes in 2000 to 17 % in 2004.<sup>3</sup>

The average corporate income tax of the most industrialized countries has fallen from 34 % in 2000 to 26 % in 2005.<sup>4</sup>

There is also a clear gap between the North and the South: In the rich countries

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<sup>1</sup> Definition in “tax us if you can”, a Taxjustice Network Briefing paper, September 2005

<sup>2</sup> Sikka, P. (2003) A Taxing Account of Corporate Social Responsibility, The Guardian, 17 November, in: John Christensen and Richard Murphy: The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the bottom line, Society for International Development, Development Journal, Volume 47, number 3, September 2004

<sup>3</sup> Tax revenue from income, capital and church tax on federal, state and community level. Basis is a stock company with capital and reserves of 2 million francs and a profit before taxes of 80'000 francs. Source: Swiss Federal tax department, 2005

<sup>4</sup> Statistics of the Organisation of Economic Cooperation and Development (OECD)

overall revenue from taxation between 1990 and 2000 averaged 30 % of GDP.<sup>5</sup> In sub-Saharan Africa the average over the same period was 17,9 % of GDP, in Latin America 15,1 % and in south Asia 10,5 %.<sup>6</sup> The consequences are particularly dramatic for developing countries, since they need tax revenues to fight poverty and to promote development.

It is estimated that 1 trillion US\$ a year of “dirty money” flows into the global banking system, half of which comes from developing countries and the transition economies (countries emerging from the legacy of Soviet control). These 500 billion US\$ are more than six times the current global aid budget. Tax avoidance by companies, especially by multinational corporations accounts for 200 billion US\$ of this figure.<sup>7</sup>

With a supposed corporate income tax rate of 20 % developing countries and transition economies are losing 40 billion US\$ in taxes every year due to tax avoidance by companies. Developing countries are losing further 35 billion US\$ in taxes each year due to lower corporate tax rates than in the industrialized countries.<sup>8</sup>

One often used method of shifting away profits is so-called transfer pricing. (FOLIE 7) It is the setting of prices in transactions between divisions and companies belonging to the same multinational. Transfer pricing has become more and more important, since the number of multinationals and subsidiaries has grown enormously.<sup>9</sup> A lot of these companies are managed on intra-national or even global lines, not national ones. An extraordinary 60 % of today’s international trade takes place within multinationals.<sup>10</sup>

In the 1990s the OECD released transfer pricing guidelines on the basis of the arm's length principle (FOLIE 8). This principle means that the prices in intra-group transactions should be comparable to prices between independent companies. But transfer pricing is open to manipulation. A report to the US-Senate in 2001 claimed that multinationals evaded paying up to 45 billion US\$ in American taxes in 2000 through transfer pricing.

Because of its attractive tax regime Switzerland is less concerned with abusive transfer pricing, that shifts profits abroad. In addition Swiss tax law does not specifically address the issue of transfer pricing and there are no specific domestic documentation provisions like for example in Germany. However the Swiss tax authorities follow the OECD guidelines closely in transfer pricing matters.

A lot of the money, that evades being taxed, goes to so called tax havens. They play a key role in the tax avoiding industry. There are around 70 worldwide, among them Switzerland. We define them as places with a strong secrecy and poor regulation, where non-residents pay little or no tax.

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<sup>5</sup> OECD-countries

<sup>6</sup> Alex Cobham, Taxation Policy and Development, The Oxford Council on Good Governance, April 2005, in: The Shirts Off Their Backs, How tax policies fleece the poor, Christian Aid, September 2005

<sup>7</sup> Raymond Baker, Capitalism’s Achilles Heel, August 2005, in: The Shirts Off Their Backs, How tax policies fleece the poor, Christian Aid, September 2005

<sup>8</sup> Tax Havens Releasing the Hidden Billions for Poverty Eradication, Oxfam UK, 2000

<sup>9</sup> The number of the multinational companies has grown from 37’000 (with 175’000 foreign subsidiaries) in the early 1990s to 64’000 (with 870’000 foreign subsidiaries) in 2003.

<sup>10</sup> The Economist, January 29, 2004

Tax havens are a unique instrument for multinationals to “optimize” their taxes. US Energy giant Enron for example owned 692 subsidiaries in the Cayman Islands in 2000, the year before it went bankrupt.<sup>11</sup> In 1999 US-multinationals possessed 400 billion US\$ of untaxed earnings in offshore havens. By the end of 2002 the amount was about 639 billion US\$.<sup>12</sup> Companies for offshore purposes are now being established at the rate of around 150'000 per year. It has been estimated that nearly half of the world's trade in goods and services is transacted through offshore finance centres.<sup>13</sup>

Tax havens encourage corruption, capital flight, tax avoidance and evasion by multinationals and rich individuals. Tax havens also undermine international financial stability. Ordinary citizens and smaller domestic businesses will lose out. They bear the costs in two ways: On the one hand, governments increase taxes on consumption, smaller incomes and smaller businesses. On the other hand, governments cut their expenditures for investments in public infrastructure.

Without accounting firms multinationals wouldn't be so efficient and aggressive in their tax avoidance. Accounting firms play an important role by creating new tax avoiding schemes for their clients. According to a new report by the United States Government Accountability Office<sup>14</sup>, 207 of the 500 biggest companies worldwide obtained tax shelter services from specialised firms. The estimated potential tax revenue loss to the US government over many years concerning these 207 companies was about 56 billion \$, nearly half of it related to tax years 1998 to 2003.

A few weeks ago KPMG, one of the biggest accounting firms, agreed in a settlement with the US Department of Justice to pay 456 million US\$ in penalties after selling “fraudulent” tax avoidance schemes to clients. In addition the firm will be put on probation until the end of 2006 and for the next three years KPMG's conduct will be monitored.

As this example shows, different countries and international organisations have intensified their activities to stop and prevent tax avoidance and tax evasion. In 2000 the OECD published a blacklist of 35 offshore tax havens, not members of the OECD. All were asked to meet the requirements of the OECD especially concerning the exchange of information in tax matters. Otherwise they would be subject to sanctions.

But the progress made by the majority of tax havens in the early years of this decade has amounted to little more than a commitment to cooperate. Since 2003 there has been little progress around the issue as many of the tax havens are demanding a level-playing field treatment alongside the major European havens like Switzerland and Luxembourg.

The OECD also published a list of OECD-countries like Switzerland with potentially harmful tax practices. They concern especially preferential tax regimes for holding

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<sup>11</sup> William Brittain-Catlin, OFFSHORE, The Dark Side Of The Global Economy, New York, 2005

<sup>12</sup> Ibid.

<sup>13</sup> [www.offshore-company.org](http://www.offshore-company.org), [www.ukincorp.co.uk](http://www.ukincorp.co.uk)

<sup>14</sup> „TAX SHELTERS Services Provided by External Auditors”, Report of the United States Government Accountability Office to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate, February 2005

companies. Switzerland meanwhile has succeeded in getting off this list. Now the Commission of the European Union has sent a letter to the Swiss authorities asking them informations regarding the preferential tax regimes

Tax authorities are also increasingly attacking the transfer pricing policies of group companies. Several countries like Germany have issued new transfer pricing legislation and regulations. As a consequence in a survey of 800 international companies in 2003, 68 % of all respondents declare, that transfer pricing would be the biggest international tax issue they would face in the next two years.<sup>15</sup>

All British Companies in the financial service sector must now disclose tax avoidance schemes. At the end of January 2005 the number of aggressive arrangements disclosed to the Inland Revenue passed the mark of 500.

What are the necessary measures to be taken in the future to stop aggressive tax avoidance and harmful tax competition? To clarify I am not in favour of an international tax harmonization as every country should continue to have its own tax policy. However the scope of the states to determine an autonomous policy is limited by the behaviour of multinational companies.

So long as tax havens with a strong banking secrecy exist, so long as loopholes in the national tax legislations exist, so long as there are no strong international regulations in tax matters and so long as multinationals don't need to publish what they pay, they will always be tempted to avoid taxes.

However multinational companies can't ignore the opinion and interests of the shareholders, the investors, the public and the media. If the companies want to ensure a good corporate governance and a good image they need to adopt clear corporate social responsibility standards in the area of taxation. These standards for example would include that the companies publish, where they generate their profits and where they pay their taxes and how much.

In addition, we propose:

- a common definition of what constitutes taxable profit and a common basis for attributing profit to the different countries in which a company operates.
- international accounting standards that provide more transparency in tax matters
- the loopholes in national legislations should be shut down. The preferential tax regimes for non-residents or holdings in national legislations should be abolished.
- jurisdictions, which don't have a good regulation of their banking system and which don't cooperate fully in information exchange should be sanctioned.
- an automatic information exchange between all financial institutions and the tax authorities should be introduced
- a global minimum rate of corporate taxation should be considered, to stop the race to the bottom between nation states.
- companies in the financial sector should disclose their tax avoiding schemes.
- national laws should endorse general anti-avoidance principles.
- a new bureau within the tax department of each country could be created that develops means to counter offshore evasion and avoidance.

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<sup>15</sup> Ernst & Young, Transfer Pricing 2003 Global Survey

- international tax cooperation should be strengthened. Developing countries should get more international assistance in tax matters and building up an efficient tax authority.
- A World Tax Authority (WTA) should be created to monitor the impact of fiscal policies and to create international guidelines.

Thank you for your attention. For more information:

[www.aktionfinanzplatz.ch](http://www.aktionfinanzplatz.ch)

[www.taxjustice.net](http://www.taxjustice.net)

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