Symposium on IFFs: Global Minimum Tax Without Global Impact: Examining the OECD’s Pillar 2 and its Potential Impacts on Illicit Financial Flows

By:

Opeyemi Bello

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Illicit Financial Flows and Potential Abusive Tax Avoidance

This blog offers alternative approach, which I describe as potential abusive tax avoidance (PATA), to evaluate incidences of illicit financial flows (IFFs) in Africa. By way of a working definition, PATA arises when there is a greater probability that a proposed tax legislation is susceptible to abusive tax avoidance. The abuse contemplated under the PATA is similar to Steve Dean’s argument of how considerable degree of taxpayer autonomy– under the guise of tax deregulation - can negatively impact a nation’s tax system. PATA provides a complimentary mechanism to examine how a proposed international tax framework can result into IFFs. I undertake this analysis using the global minimum tax proposed by the OECD to address tax consequences of the digitalized economy.

There is consensus that tax evasion – the deliberate act of non-compliance with tax laws requiring payment of taxes to entitled states - is one of the practices that generate IFFs. Abusive tax avoidance – the improper use of loopholes and benefits in tax laws - can equally contribute to the IFFs. How both tax evasion and abusive tax avoidance can result into IFFs in Africa is visible when the tax framework is operational. I am of the view that we do not need to wait till the proposed legislation becomes operational before its IFFs consequences in Africa are examined. This is where PATA becomes a handy toolkit to examine the IFFs consequences of the proposed framework and provide guidance on how states can address those consequences.

The core objective of the several initiatives on the IFFs in Africa is that African states should not lose to the IFFs revenues that are much needed for their development and welfare of their people. Discussions on the IFFs are a top priority for Africa considering the large amount lost annually to the IFFs, which was estimated by the United Nations Economic Commission for Africa (UNECA) in 2015 to be above $50billion annually. The UNECA acknowledges that the estimated figure of $50 billion does not reflect the actual amount lost to the IFFs because of insufficient data to compute the accurate figure. Considering the UNECA's acknowledgement, it is probable to conclude that amount lost to the IFFs annually is exceedingly high and might be beyond accurate computation. The African states in the OECD Global Forum on Tax Transparency and Exchange of Information for Tax Purpose established the Africa Initiatives in 2014 to work with other relevant institutions in providing solutions to the IFFs in Africa. The Yaoundé Declaration of 15 November 2017 demonstrates, among other resolutions, the commitment of thirty-four African states to tackle the IFFs through international tax cooperation by ensuring that African states continue to embrace the mechanism of automatic exchange of information (AEOI) of taxpayers.

The OECD identifies that the following four practices and methods can result into the IFFs: money laundering, bribery, trade mispricing and tax evasion by multinational companies (MNCs). The first three practices are outside the scope of this paper. Policymakers, such as the OECD and the IMF, have suggested AEOI as solutions to tax evasion by the MNCs. Considering the efficiency of the AEOI in combating the IFFs, the G20/OECD shows its commitment to addressing the IFFs by dedicating a distinct action pillar (Action 13 – Country-by-Country Reporting) to AEOI in its ongoing works on base eroding and profit shifting (BEPS). The UNECA's 2015 report introduces an interesting dimension to the relationship between tax evasion and tax avoidance for the purpose of determining the scope of the IFFs. It states that tax avoidance by MNCs can form part of the IFFs if there is no general anti-avoidance rule (GAAR) to combat the abusive use of tax avoidance or the GAAR mechanism is ineffective. It thus becomes clear that there is a blurring line between tax avoidance and tax evasion even though the former may be legitimate if properly used for the intended purpose of the taxing legislation.

The OECD's recommendation of AEOI seems to be sufficient to address tax evasion practices to a greater extent. We need to reflect broadly on how abusive tax avoidance can possibly result into the IFFs. The UNECA report suggests two instances where tax avoidance can become part of the IFFs: absence of GAAR and ineffective GAAR. The UNECA's position on abusive tax avoidance makes senses when there are loopholes in the tax legislation, which taxpayers can leverage to minimize their tax liabilities. There must first be loopholes or tax incentives in the tax codes before GAAR can be useful to prevent abusive use of those loopholes and incentives. But how do we construe tax avoidance in the absence of an operational tax legislation? I am of the view that the proposed tax legislation should be examined to determine if its provisions are susceptible to being abused by taxpayers in the guise of legally avoiding tax liabilities. It should also be examined whether the proposed legislation anticipates such acts of PATA and provides measures to curb them. Economic analysis of such proposed legislation will enable affected taxing states to foresee - and provide remedial measures - potential revenues loss that will arise from the PATA.

To fully realize the African states' objective of preventing loss of their much-needed revenues to tax evasion and abusive tax avoidance by the MNCs, the African states need to examine susceptibility of proposed international tax frameworks to abuse by the MNCs. The OECD's proposed global minimum tax is a good case study to examine my argument on PATA. The global minimum tax has been described as a framework that ensures that MNCs pay their fair taxes, which should not be less than fifteen percent, to jurisdictions where they operate. If the global minimum tax is really designed to achieve payment of fair taxes to all eligible jurisdictions, it means that the new tax framework should have positive impact on states' development. Drawing from the PATA analysis, I examine some provisions in the global minimum tax to explain how the MNCs can leverage the loophole or abuse the provisions in a manner that affects realization of African states' objectives in the IFFs programmes. Conceptual analysis of the global minimum tax will be a good prelude to application of the PATA analysis to the global minimum tax.

Global Minimum Tax

Global minimum tax is a part of the second pillar of the OECD's two-pillar approach to addressing the tax consequences of the digitalized economy. The other part of the second pillar is the Subject to Tax Rule (STTR). The STTR allows sources countries (where the payments are made) to impose additional taxes on certain payments (such as interest and royalties) between related entities when those payments are taxed below 9% in the residence countries (where the payments are received). The STTR is outside the scope of this paper. The global minimum tax is designed for instances where a subsidiary of MNCs pays tax (at an effective tax rate below 15%) to the jurisdiction where the subsidiary operates. In that case, the MNCs or the subsidiary has the obligation to pay to the eligible jurisdiction the additional tax (described as top-up tax) to make it up to the minimum tax of 15%. The rules on global minimum tax are contained in a well detailed framework, known as the Global Anti-base Erosion (GloBE) Model Rules The GloBE rule leverages its three complimentary rules – qualified domestic minimum top-up tax, income inclusion rule (IIR) and undertaxed payment rule (UTPR) – to re-allocate taxable profits to low-taxed jurisdictions (the jurisdictions where the subsidiary's tax is below 15%).

GloBE seeks to regulate race to the bottom (known as tax competition) among states by ensuring that effective tax rate of eligible MNCs should not be below 15%. States use their tax systems to compete – to attract foreign investments by lowering their tax rate or offering other tax and not-tax incentives. The MNCs leverage these differential tax regimes to shift their profits from high-tax jurisdictions to low-tax jurisdictions to minimize their tax liabilities. The MNCs will be discouraged from aggressive use of this profit-shifting strategy since their effective tax rate will not be below 15% irrespective of jurisdictions to which their profits are shifted. The anti-competition objective of the second pillar makes the framework attractive to the majority of high tax jurisdictions, such as the United States, but some historically known attractive tax jurisdictions, such as Singapore, has expressed their concerns on the effect of the second pillar on their sovereignty.

The Battle between the Global Minimum Tax and the IFFs: A PATA Analysis

The GloBE's idea seems attractive and beneficial to African states considering the fact that GloBE may reallocate to African states additional tax revenues that may be used for realization of their sustainable development goals. However, there are some provisions in the GloBE that are susceptible to abuse by taxpayers. The resulting effect of the abusive practice will defeat the purpose of GloBE and be inimical to the interests of African states. I highlight few of them in the following paragraphs.

a. Eligible Jurisdictions for Additional Tax (Top-up Tax Amount)

The fundamental condition that triggers application of the GloBE rule is that the MNCs must have a minimum of annual revenue of EUR750 million in at least two of its four fiscal years preceding the year when the rule is applied. In addition to the revenue test, the multinational group must have at least one entity or a permanent establishment (PE) in other countries outside the country of its ultimate parent entity. The definition of an entity is straight forward – it is not different from the traditional meaning of a subsidiary company formed under the domestic laws of the foreign countries. There are, however, some loopholes in the definitions and requirements of the eligible PE under the GloBE rules.

A PE is a threshold of business activities of foreign companies in source countries which triggers the taxing right of source countries. Provided that the business activities reach the statutory or the treaty-defined PE threshold, the source countries can impose tax on incomes (earned within their jurisdictions) of foreign companies even if the foreign companies do not establish a subsidiary in those countries. By Article 10, GloBE recognises only four categories of the PE: a treaty-based PE (used where there is a tax treaty), a domestic law-based PE (used where there is no tax treaty but the source country has a corporate income tax), an OECD model-based PE (used where the source country has neither a tax treaty nor a corporate income tax), and a stateless PE (used where the foreign operation does not fall under any of the three preceding categories).

There must be at least one of these four categories of the PE in a source country before the source country can make any claim for re-allocation of profit under the GloBE. None of the four categories of the PE recognises virtual foreign business operations as PEs. In this era of strong wave of digitalized economy, non-inclusion of virtual operations creates a loophole that can be abused by the MNCs. It is concerning that the OECD does not consider in the GloBE that virtual business operation can be an alternative way of creating nexus with the source countries in the same manner as the traditional PEs, but in another breadth of its work on the first pillar it acknowledges that virtual operations can create nexus that triggers taxing rights of the source countries. Considering Sol Picciotto's analysis of how the MNCs leverage their expertise to reduce their tax liabilities through strategic international business arrangement, there is possibility that the MNCs can deliberately design their foreign operations to be virtual to legally escape the obligation of top-up tax that may arise from their operations in other locations outside their home countries. African states are 'endangered species' in this regard. They will neither be able to exercise their original taxing rights on virtual business activities under tax treaties nor make any claim for top-up tax under the GloBE because virtual operations are incapable of constituting PEs under both the current international tax framework and the GloBE.

b. Business Combination

In the case of mergers, the revenue threshold requirement is computed by adding the total revenues of the different components of the newly merged entity under Article 6. The new entity falls within scope of the GloBE rule if the total sum of revenues of its components are equal to or exceed the revenue threshold of EUR750million. However, in the case of demergers, where the larger group is restructured into different groups, the respective revenues of each demerged group are separately considered for the purpose of applying the rule. The GloBE rule can only apply to each of the demerged group if each of them meets the revenue threshold.

The rule does not envisage that some MNCs may engage in a deliberate business re-organization to avoid the rule. The MNCs are not committing any offence in designing their business affairs as they wish according to the popular case of Duke of Westminster, but the policy makers must be proactive in identifying such cases - and providing remedial measures - long before they occur. If a MNC that is previously within the GloBE decides to split into 2 groups and the respective revenues of each of the demerged groups consequently fall below the revenue threshold, the implication is that the two groups are exempted from the GloBE rule and the net benefit of the reorganization may eventually accrue to a distant and discreet beneficial owner.

c. Re-allocation of profit through the mechanisms of the IIR and the UTPR

By Article 2 of the GloBE, the IIR and the UTPR determine the top-up tax (additional tax) that will be paid by taxpayers whose effective tax rate is below the minimum tax rate of 15%. The IIR is used by the country of parent entity of the group while the UTPR is used by other countries, where the other entities of the group are located. Assuming the African states embrace and domesticate the GloBE, they are likely to use the UTPR for majority of companies that fall under the GloBE as these companies are likely to situate their parent entities outside Africa. Computation of the UTPR is factor of number of employees and tangible assets. Jurisdictions with few employees and tangible assets will be entitled to a relatively lower UTPR amount. African states are likely to have lower proportion of employees and tangible assets not because there are no sufficient labour activities in those countries but because the MNCs may deliberately consider outsourcing jobs to independent contractors rather than direct employment. The argument of the Meta Platform (the owners of Facebook), in a recently decided case in Kenya, that its content moderators that it engaged through a recruiting company are not its employees is proof of how the MNCs can attempt to avoid liabilities through job outsourcing.

d. Initial Phase of International Activity

By Article 9.3 of the GloBE, the top-up tax is reduced to zero for the purpose of the UTPR for any MNC in its initial phase of its international activity. The initial phase is the period where the MNC has constituent entities in not more than six jurisdictions and the sum of the net book values of tangible assets of all these constituents in all jurisdictions, other than the jurisdiction where it has the highest total value of tangible assets, does not exceed EUR 50 million. The OECD does not envisage the possibility that MNCs may deliberately limit their operations within this exemption to take the benefit.

e. De Minimis Clause

MNC Group has a discretion to deem a top-up tax of a jurisdiction to be zero under Article 5.5 if the average GloBE revenue of such jurisdiction is less than EUR 10million and the average net GloBE income is negative (loss) or less than EUR 1million. This is known as the principle of 'De minimis exclusion'. The conditions are cumulative and carried out every year. A jurisdiction that qualifies for the de minimis exclusion in the current year may not qualify next year. This implies that no additional tax may be payable to that jurisdiction because top-up tax is the basis for computation of the GloBE rules. De minimis clause is generally an efficiency tool that compares the tax revenue with the cost associated to collection of the revenue. The clause makes a tax instrument efficient by exempting from tax items that are otherwise taxable, but the collection cost exceeds the tax revenue on those items. De minimis clause is largely beneficial in national tax systems as tax authorities can derive some other benefits that will compensate the foregone taxes. It is doubtful that if the De minimis clause can offer the same benefit in international tax agreement considering the fact that the items or amounts that are considered trifle for developed countries and therefore eligible for De minimis clause can be significant tax amounts for developing countries.

Should African States abandon the Global Minimum Tax?

As earlier said, the GloBE's idea to reduce competition and re-allocate profit to low-taxed jurisdictions seems attractive. On that basis alone, African states should not quickly condemn the proposed framework. They only need to reflect on the issues I identify and renegotiate them to protect their interests. The OECD's goal of minimizing compliance and administration cost under the GloBE should be balanced with potential revenue loss to the African states from aggressive and abusive use of the loopholes in the proposed framework.

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