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9

Accounting for the Missing Billions

Richard Murphy

This chapter considers, first, whether substantial transfer mispricing by major corporations that contributes to a loss of at least US$160 billion a year to developing countries is plausible in the context of total likely corporate profits earned worldwide in a year.[1]

Second, it tests whether corporate activities in developing countries and in the extractive industries in particular might be especially prone to this abuse.

Third, it considers whether this sum could be hidden from view within the accounts or financial statements of the multinational corporations (MNCs) that might be perpetrating the mispricing.

Fourth, it explores the possibility that the MNCs might use secrecy jurisdictions to assist in hiding these transactions from view.

In each case, it is suggested that the behavior described is plausible and that, as a consequence, losses of the estimated amount are also plausible, although not proven to exist as a result of this work.

Some of the data used in this chapter have been researched for the Mapping the Faultlines Project of the Tax Justice Network (TJN), financed by the Ford Foundation, the results of which are being published at http://www.secrecyjurisdictions.com/. The author is research director of that project.

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Introduction

Since 2000, a body of literature, mainly emanating from nongovernmental organizations (NGOs), has developed suggesting that systematic transfer mispricing is taking place within the world's MNCs. This literature asserts, in the first instance, that the flows in question abuse international standards on transfer pricing implicit in the arm's-length pricing rules of the Organisation for Economic Co-operation and Development (OECD) and that the abuse results in significant loss in revenues to developing countries.[2]

Estimates of the loss vary. Christian Aid's estimate (2008) finds that transfer mispricing and related abuses result in the loss of corporate tax revenues to the developing world of at least US$160 billion a year, a figure that, it notes, is more than 1.5 times the combined aid budgets of the rich world, which totaled US$103.7 billion in 2007.

Raymond Baker (2005) proposes that total annual illicit financial flows (IFFs) might amount to US$1 trillion, asserting, in the process, that these flows pass illegally across borders aided by an elaborate dirty money structure comprising tax havens, financial secrecy jurisdictions, dummy corporations, anonymous trusts and foundations, money laundering techniques, and loopholes intentionally left in the laws of western countries.[3] Of this amount, Baker estimates that some US$500 billion a year flows from developing and transitional economies. He suggests that at least 65 percent of these flows may be accounted for by transfer mispricing.

Baker's findings have been endorsed by Kar and Cartwright-Smith (2008), who estimate that, in 2006, developing countries lost US$858.6 billion to US$1.1 trillion in illicit financial outflows. Note that the term illicit is appropriately used in this chapter. The *Oxford English Dictionary* defines illegal as contrary to or forbidden by law, but illicit as forbidden by law, rules, or custom. The distinction is important. Transfer mispricing is illicit; it is contrary to known rules or customs, but, in many of the transactions of concern, it is not illegal because, as noted later in this chapter, double tax agreements (DTAs) that would make it so are not in place, nor are relevant local laws.

NGOs and civil society organizations are not the only source of literature proposing that transfer mispricing might be used to reallocate profits across jurisdictions. There is a substantial body of academic literature

asserting that this practice is commonplace, although this literature does not focus on developing and transitional economies in coming to its conclusion. For example, Dischinger and Riedel (2008) state that intangible assets such as patents and trademarks are increasingly seen as the key to competitive success and as the drivers of corporate profit, but also constitute a major source of the opportunity for profit shifting in MNCs because of the highly nontransparent transfer pricing process. They argue that this provides MNCs with an incentive to locate intangible property in jurisdictions with relatively low corporate tax rates. They find evidence to support this activity, showing that the lower a subsidiary's tax rate relative to other members of a multinational group, the higher the subsidiary's level of intangible asset investment.

Harry Huizinga (2009), in a wide-ranging review, indicates that MNCs can relocate profits in a number of ways. First, they could change real activity, that is, where they locate; second, they could manipulate transfer prices; third, they could choose the location of intangible assets and associated income such as royalties (as Dischinger and Riedel emphasize); or, fourth, they could choose the location of their headquarters to create possible favorable international double taxation consequences. Having reviewed the current literature within Europe on this issue, Huizinga concludes that international profit shifting erodes the corporate tax base in Europe, that the best approach to tackling the problem is to eliminate incentives for firms to shift profits, and that international policy cooperation is necessary to achieve this.

Notably, the academic studies, in contrast to those by NGOs, find that the scale of income shifted is relatively small, only a few percentage points, at most, of the tax base. For example, in chapter 4 in this volume, Fuest and Riedel posit that Baker (2005), Kar and Cartwright-Smith (2008), Christian Aid (2008), and others all overstate the extent of transfer mispricing, although all these authors reject the assertion because Fuest and Riedel make a fundamental error by assuming that overpriced inflows and underpriced outflows may be netted off for the purposes of assessing resulting tax losses, when, in fact, these sums should be aggregated for this purpose. In chapter 10 in this volume, Nitsch also questions the same group of estimates, suggesting that the forging of documentation relating to IFFs may not be motivated by taxes. It is a curious argument if the consequence is tax loss whatever the motive.

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There are, however, reasonable methodological grounds that explain why this low level of transfer mispricing is reported by academic studies, all these grounds deriving from significant methodological weaknesses in the studies.

First, most academic studies on this issue use database information supplied by agencies that summarize accounting data; as a result, they do not use the accounts themselves as their data source, losing considerable vital information on tax as a consequence (see below).

Second, these data sets tend to result in the use of pretax profit as a proxy for taxable income—which is rarely appropriate—and in the use of profit and loss account tax charges as a proxy for taxes paid. This use of the profit and loss account tax charge as an indicator of taxes paid is almost always inappropriate. This is because these charges are invariably made up of two parts. The first is the current tax charge. This is the tax that a company actually believes will be paid within 12 months of a period end as a result of the profit arising during the accounting period. It is, therefore, a reasonable measure of the tax liability accruing during the period. The second component of the tax charge in a profit and loss account is described as the deferred tax charge. Deferred tax is not tax at all. Rather, it represents an accounting entry relating to taxes that may potentially (but will not definitely) be paid in future periods as a consequence of transactions that have occurred in the current period. So, for example, if the tax relief on the acquisition of fixed assets in the period exceeds the charge for depreciation on these assets in the profit and loss account, there is a potential deferred tax charge in future periods if the situation were to reverse. The liability is provided in the accounts, even though it may never arise simply because the situation may not reverse. Similarly, if transfer mispricing can defer the recognition of profit in a high-tax parent-company location by the current relocation of the profits in question to a secrecy jurisdiction where tax is not currently due on the profits, then a deferred tax provision can be made for the potential liability arising on the eventual remittance of the profits to the parent company, but there is no guarantee that this sum will ever be due. As a consequence, many consider deferred tax charges as accounting fiction and as unreliable, and they are, curiously, the only liability included in the set of accounts whether or not there is any pros-

pect of their settlement. In this case, to include them in the tax charge in considering the real taxation paid by corporations is seriously misleading and undermines many existing studies of effective taxation rates among MNCs. Thus, the methodology used in these studies is inappropriate for appraising the transfer mispricing that these studies survey.

Using accounting data from the companies, Murphy (2008) shows that the largest 50 companies in the FTSE 100 increased their net deferred tax provisions (that is, the cumulative provisions that are made by a company for deferred taxation arising over the period of trading to date and that are shown as a long-term liability on balance sheets) from £8 billion to £46 billion between 2000 and 2006. This hints at the existence of significant tax avoidance that database information on the taxation charges in company accounts is unlikely to reveal.

The room for disagreement is thus substantial on whether there is, or not, a major transfer mispricing issue that might have particular relevance to developing nations and in which secrecy jurisdictions may play a significant part in a way that policy change may need to address.[4]

It is not the purpose of this chapter to resolve whether the mispricing takes place or not. The chapter has another purpose, which is approached from an accounting and auditing perspective. An audit tests the credibility of reported data. This is not a test of whether the variable is right or wrong: financial audits do not offer an opinion on this to their users. Instead, the audit seeks to test whether the variable may be true and fair. In seeking to prove or disprove the credibility of data, auditors have, for some time, realized that a microapproach, that is, verification based on transactional data alone, is unlikely to provide all (and, in some cases, any) of the data needed to determine the likely credibility of the overall stated position. The alternative approach involves verifying data by testing the credibility of sums in total.

This testing can take a number of forms. For example, do the data fall within the known range of plausible outcomes based on the third-party data that are available? Alternatively, are the data within the likely pattern of outcomes that may be observed within the entity that is being tested? And are the total data plausible in that they are consistent with other known totals?

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Importantly and, in the current case, crucially, all such tests must take into consideration the broader commercial, regulatory, legal, and risk environments in which the transactions or balances being considered occur. An auditor is not allowed to consider numerical data in isolation; the use of such data must be contextualized.

This chapter seeks, first, to test the hypothesis according to which transfer mispricing by major corporations that gives rise to tax losses amounting to at least US$160 billion a year among developing countries is plausible in the context of the total likely worldwide corporate profits in a year during the same period of reference (that is, pre-2008).

Second, it tests whether corporate activities in developing countries and, particularly, in the extractive industries may be especially prone to this abuse.

Third, it considers whether this sum may be hidden from view within the accounts and financial statements of the MNCs that might be perpetrating the mispricing.

Fourth, it explores the possibility that MNCs may use secrecy jurisdictions to assist in hiding these transactions from view.

The rest of the chapter is divided into five sections. The next section explores the tax rates that MNCs have and are likely to face; it shows that much of the existing literature on this subject offers misleading indications of likely effective tax rates.

In the subsequent section, the state of transfer pricing regulation and practice within the extractive industries is explored on the basis of a range of sources on which the author has worked over a number of years.

The following section looks at the way in which MNCs are structured and how this structure interacts with the corporate and tax law of the locations that host some of these MNCs; it also contrasts these relationships with the requirements of International Financial Reporting Standards (IFRSs), which are the standards that govern the financial reporting of most such entities now that U.S. Generally Accepted Accounting Principles are converging with the standards issued by the International Accounting Standards Board.

The penultimate section considers the nature of secrecy jurisdictions. Data on the use of such locations by MNCs are presented. The role of the Big Four accounting firms is touched upon.

The evidence is drawn together in the concluding section.

Multinational Corporations and Their Tax Rates

Data sources

This part of the chapter seeks to compare the corporate tax rates offered by a wide range of jurisdictions over time. The basic data source for the time series data on tax rates used in this report is the annual corporate tax rate reviews published by KPMG, a Big Four firm of accountants and business advisers. KPMG has been publishing the reviews since 1996, and, although the jurisdictions reviewed have varied slightly over the period, the data have always covered between 60 and 70 jurisdictions in each annual report up to and through 2008, all of which have been included in the current survey. The KPMG data consistently cover 30 OECD countries and the 15 preenlargement members of the European Union (EU). The other jurisdictions surveyed vary widely. A consistent feature is that few of the places are recognized secrecy jurisdictions. The data on populations and gross domestic product (GDP) used in this part of the chapter were extracted from the CIA Factbook in July 2009.[5]

As a result of the omission of tax rate data for secrecy jurisdictions, an alternative data source for these locations has been used. Given that the KPMG data were, without doubt, produced for marketing purposes, another, similar source has been sought. The source the author of the chapter has settled on is a data set downloaded from OCRA Worldwide.[6] These data, which were extracted in November 2008, relate to the corporate tax rates of secrecy jurisdictions as applied to foreign source income. This is relevant for the purpose of this review because one is concerned with transfer pricing, and the income that will pass through these locations in connection with intragroup trades is likely to be considered foreign source income in these jurisdictions; the tax rates provided by OCRA will therefore be the appropriate tax rates to consider.

Methodology

The KPMG data are summarized in table 9A.1.[7] The data are categorized according to the following characteristics for the purposes of the analysis:

1. Whether or not the jurisdiction was a member of the OECD
2. Whether or not the jurisdiction was one of the 15 EU preenlargement states (the EU15)

3, Whether the jurisdiction was large or small (for these purposes, a large jurisdiction has a population over 15 million, which splits the data into two broadly equal parts)
4. Whether the jurisdiction had a high or low GDP per head (for these purposes, a high GDP is above US$25,000 in 2009, which splits the data into two roughly equivalent parts)
5. Whether or not the jurisdiction had a high proportion of government spending in relation to GDP (in this case, 30 percent government spending as a proportion of GDP indicates high spending)

The categories have been chosen broadly to reflect developed and less-developed nations (the developed nations are the OECD members) and large and small jurisdictions. Categorizing according to a high or low tax spend also broadly reflects the effectiveness of the tax system in the jurisdiction because it is likely that those jurisdictions with low spending had ineffective tax collection systems given that this is commonplace in developing countries.

The average data for each year have then been calculated for each of these groups. The resulting data set is reproduced in table 9A.2.[8]

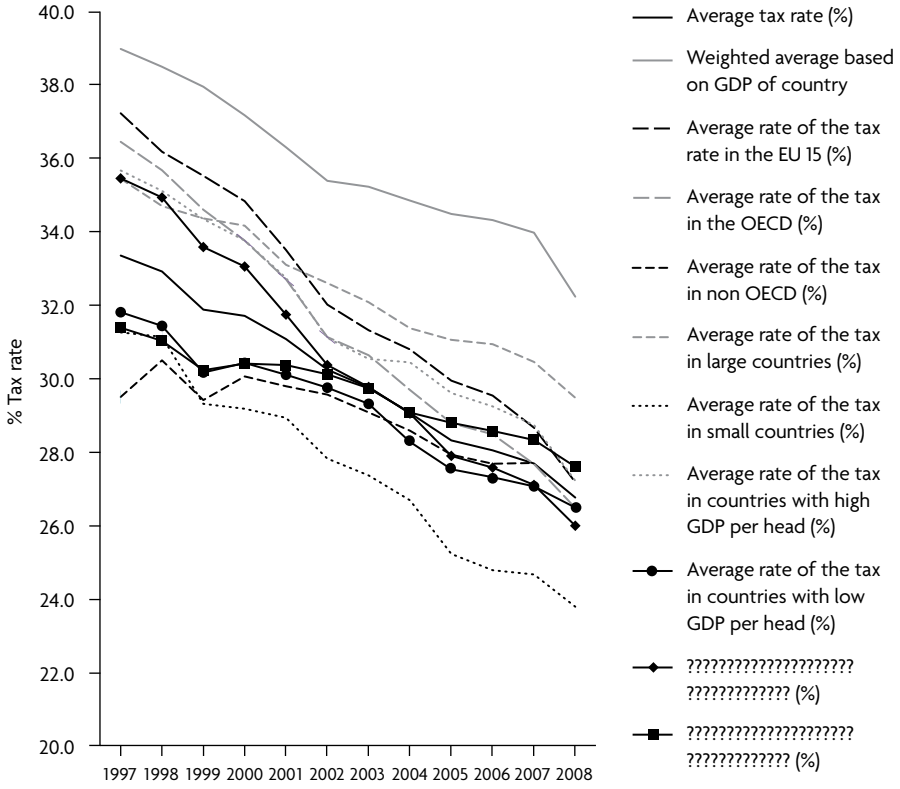
Initial results

The initial results are best presented graphically. An overall summary of the data is shown in figure 9.1.

There is a strong and, in almost all cases, persistent downward trend in nominal corporate tax rates over the period under review. This, however, does not reveal much of the subtlety inherent in what is happening, which greater exploration of the data reveals.

First, with regard to the OECD countries (of which the EU15 are an effective subset), there has been a significant decline in notional rates that has seen them converge with the rates offered by the other, non-OECD countries. Rather surprisingly, in 2008, OECD country rates fell, on average (weighted by the number of countries), below the average rate of non-OECD countries. Given the substantial differential of more than 6 percentage points in 1997, this is a remarkable change. The playing field, much talked about in OECD circles over many years, appears to have been leveled.

Figure 9.1. Corporate Tax Rates, Initial Results, 1997–2008



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Source: Author compilation based on data of Tax Tools and Resources (database), KPMG, Zug, Switzerland, http://www.kpmg.com/Global/en/WhatWeDo/Tax/tax-tools-and-resources/Pages/default.aspx.

This story is not repeated elsewhere. The data for large and small jurisdictions do, for example, show a persistent gap in tax rates between these two groups, the extent of which marginally increases during the period. The trend in rates seems clear: smaller jurisdictions (those with populations of less than 15 million people) would appear to wish to create competitive advantage by having lower corporate tax rates.

This trend is also found by comparing jurisdictions with high GDP per head and jurisdictions with low GDP per head. In this case, it is, however, clear that the margin is closing: a level playing field is being created between these sets of jurisdictions. This is not surprising: there is significant overlap between the high-GDP jurisdictions and the OECD countries.

A comparison of jurisdictions with high and low state spending in proportion to GDP shows an even more marked contrast. Quite surprisingly, by 2008, the jurisdictions with high state spending (in excess of 30 percent in proportion to GDP) were offering lower notional corporate tax rates than jurisdictions with a lower (under 30 percent) proportion of GDP going to state spending. The implications of the change would appear clear: this is the consequence of a shift in the tax burden in high-spending jurisdictions from corporations to individuals that was rapid and marked.

These findings are significant. They confirm what other literature (of which there is a considerable body) has also shown, that is, that corporate tax rates are steadily falling. However, unlike most surveys of such rates, which are concentrated most often solely on EU or OECD countries, these data show that the issue of changing corporate tax rates is more complex than one may suspect at first sight.[9] There are strong differences in the trends that a simple analysis does not reveal.

Even so, the analysis noted here does not show the whole picture with regard to notional tax rates because a simple averaging methodology has been used to present the data. This means that the tax rates surveyed have been totaled over the set of jurisdictions and divided by the number of jurisdictions within the set. This standard methodology is flawed. To assume that all jurisdictions stand equal in the assessment of changes in average tax rates is inappropriate: it would seem that weighting should be an essential part of any analysis.

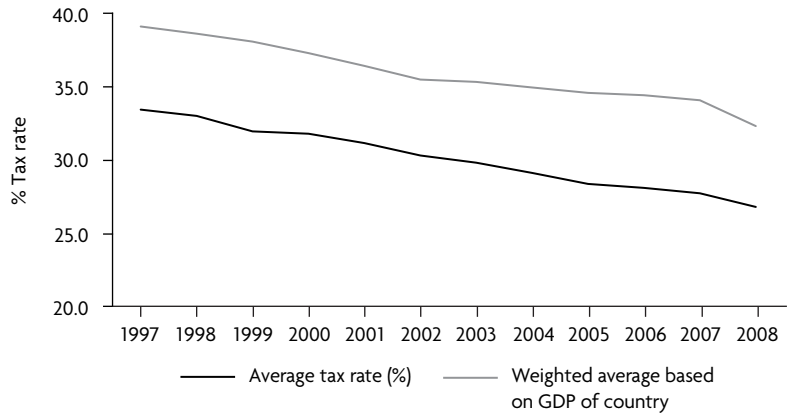
There are a number of ways to weight these data. The usual method is simply to attribute an equal weight to each jurisdiction. This would be misleading. The method gives an undue emphasis to the tax rates of small economies with limited populations. Because such economies are frequently associated with secrecy jurisdiction activity, there is an obvious risk of inherent bias. It is precisely for this reason that an alternative weighting has been used in the current exercise, resulting in a perspective that is different from the one usually provided by analyses of this sort, which are undertaken, in most cases, by members of the accounting profession, who have an inherent bias (as noted elsewhere below) toward secrecy jurisdiction activity. As a necessary alternative, a different weighting has been used here. We have weighted by the GDP of the jurisdiction offering the tax rate. There is a good reason for this choice: GDP is a reasonable indication of the size of national markets, and this is a good

proxy for the capacity to generate profits. Because this exercise is focused on the taxation of profits in particular locations, this weighting is likely to indicate the effective tax rates that companies are seeking to avoid by transfer pricing activity given that the taxation of profits is the motive for using transfer pricing. The only other viable method that might indicate the impact of profit shifting through transfer mispricing is to weight tax rates by the population of the jurisdictions: such an exercise would indicate a shift from locations with high populations, requiring taxation revenue to service local need, to locations with low population, requiring little taxation to service the needs of the population (this is also, of course, a characteristic of secrecy jurisdictions). This second weighting method is also considered in the analysis offered below.

Weighting by GDP supplies a different picture of average tax rates, as shown in figure 9.2. The weighting in figure 9.2 has been carried out using notional 2009 GDPs expressed in U.S. dollars as a consistent ranking mechanism that is unlikely to have introduced distortion because relative positions are unlikely to have changed materially for this purpose over time.

Average tax rates fall within the ranges noted within the standard economic literature mentioned above. This literature gives, however, a misleading view. Because of the presence of the biggest economy in the

Figure 9.2. Corporate Tax Rates, Weighted by GDP, 1997–2008



Source: Author compilation using 2009 GDP data taken from World Factbook (database), Central Intelligence Agency, Washington, DC, https://www.cia.gov/library/publications/the-world-factbook/

world (the United States), which has one of the highest effective tax rates on corporate profits in the world (notionally stated, as are all rates used here) if federal and state taxes are combined, and many other major countries that combine high absolute GDPs and high tax rates, the average corporate tax rate weighted by GDP is much higher than the apparent simple average; in 2008, the difference was about 5 percent.

This is significant. Murphy (2008) finds that the effective current rates of corporation tax paid by the largest 50 companies in the FTSE 100 fell steadily, from 26 percent in 2000 to about 22 percent in 2006, both compared with a headline rate of 30 percent. This closing rate differential of 8 percent looks substantially more significant, however, if it is compared with the worldwide weighted average tax rating of about 34 percent in 2007 calculated on the basis noted above. A 12 percent differential, assuming (as is likely) that many of these companies have significant sales in the United States, seems high indeed.

Including data from the OCRA data set on some secrecy jurisdictions—only those secrecy jurisdictions on which OCRA provides data have been used in the survey discussed hereafter, and only those on which OCRA provides specific rate data have been included in the exercise—changes the perspective on these data once again.[10] Data are only available for 2008; so, trend analysis cannot be offered, but, even so, the position is quite different. The data are summarized in table 9A.3.[11] The summary in table 9.1 is based on the 90 jurisdictions used for computational purposes. The equivalent data, excluding secrecy jurisdiction locations, are shown in table 9.2.

Table 9.1. Summary Data: Corporate Tax Rate, Including Secrecy Jurisdiction Locations, 2008
percent

Description	Rate
Notional simple average of corporate tax rates	20.30
Corporate tax rate weighted by GDP	32.10
Corporate tax rate weighted by population	29.90

Source: Author compilation based on data of Jurisdiction Centre (database), OCRA Worldwide, Isle of Man, United Kingdom, http://www.ocra.com/jurisdictions/index.asp; Tax Tools and Resources (database), KPMG, Zug, Switzerland, http://www.kpmg.com/Global/en/WhatWeDo/Tax/tax-tools-and-resources/Pages/default.aspx; World Development Indicators (database), World Bank, Washington, DC, http://data.worldbank.org/data-catalog/world-development-indicators/ (for GDP).

Table 9.2. Summary Data: Corporate Tax Rate, Excluding Secrecy Jurisdiction Locations, 2008
percent

Description	Rate
Notional simple average of corporate tax rates	26.77
Corporate tax rate weighted by GDP	32.10
Corporate tax rate weighted by population	29.90

Source: Author compilation based on data of Jurisdiction Centre (database), OCRA Worldwide, Isle of Man, United Kingdom, http://www.ocra.com/jurisdictions/index.asp; Tax Tools and Resources (database), KPMG, Zug, Switzerland, http://www.kpmg.com/Global/en/WhatWeDo/Tax/tax-tools-and-resources/Pages/default.aspx; World Development Indicators (database), World Bank, Washington, DC, http://data.worldbank.org/data-catalog/world-development-indicators/ (for GDP).

The secrecy jurisdictions all have 0 percent tax rates. They therefore do not change the weighted data, but they do significantly reduce the simple average data. It is obvious that excluding secrecy jurisdiction data from a sampling of average corporate tax rates, as has been conventional in most academic reviews to date, makes a substantial difference in the presentation of information. If the simple averaging method is used and secrecy jurisdictions are excluded from review, a quite misleading perspective on current likely effective tax rates is presented.

There is one computation to note. For several of the jurisdictions in the KPMG data set, OCRA notes that a differential tax rate is available for foreign source income. For these jurisdictions alone and only if OCRA could indicate the alternative rate that was available, we have undertaken further analysis using this rate for foreign source income. The jurisdictions for which this has been done are Hong Kong SAR, China; Hungary; Iceland; Israel; Luxembourg; the United Kingdom, where limited liability partnerships are tax transparent; and the United States, where limited liability companies offer the same fiscal transparency. Singapore and Switzerland offer differential rates, but we do not restate them here because OCRA does not indicate the alternative rate, which varies according to the circumstances. Our results are shown in table 9.3.

The resulting tax rate data weighted by GDP look much closer to the tax rate actually found if one examines effective corporate tax rates declared by companies, as noted by Murphy (2008), than to any tax rate data one may present by undertaking calculations weighted simply by

Table 9.3. Summary Data: Tax Rate on Foreign Source Income, Selected Secrecy Jurisdiction Locations, 2008
percent

Description	Rate
Notional simple average of corporate tax rates	18.48
Corporate tax rate weighted by GDP	20.70
Corporate tax rate weighted by population	27.20

Source: Author compilation based on data of Jurisdiction Centre (database), OCRA Worldwide, Isle of Man, United Kingdom, http://www.ocra.com/jurisdictions/index.asp; Tax Tools and Resources (database), KPMG, Zug, Switzerland, http://www.kpmg.com/Global/en/WhatWeDo/Tax/tax-tools-and-resources/Pages/default.aspx; World Development Indicators (database), World Bank, Washington, DC, http://data.worldbank.org/data-catalog/world-development-indicators/ (for GDP).

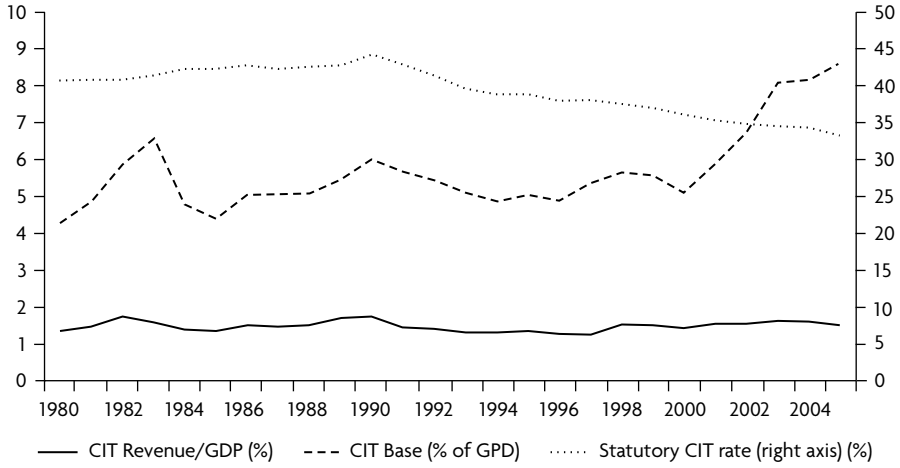
the number of jurisdictions based on the notional tax rates of all jurisdictions that are not secrecy jurisdictions. Ring-fences increase the number of jurisdictions offering low tax rates. In combination with the weighted and secrecy jurisdiction data, this understanding adds a new approach to analyzing these data.

The developing-country perspective

A final dimension to this issue needs to be noted. The KPMG data include some transition countries, but few developing countries, and Africa is, for example, seriously underrepresented. Keen and Mansour (2009) provide some data to correct this omission, although only in graphical form, as shown in figure 9.3.

The statutory corporate income tax rate plot relating to tax rates is relevant here. Simple averaging of the tax rates in Africa (with all the inherent faults in this process, which is used here, as elsewhere in most economic literature on this issue) shows that corporate income tax rates in Africa fell from 44.0 percent, on average, in 1990 to 33.2 percent in 2005. The rate of 33.2 percent might compare favorably (only barely) with the weighted average rate noted above, but it does not compare well with any other. The reality is that, on the basis of simple weighted averages, Africa has high corporate tax rates on profits, at least 5 percent above the KPMG simple weighted average for the same year and much higher than the weighted average, including secrecy jurisdictions, in 2008.

Figure 9.3. Corporate Income Tax, Africa, 1980–2005



Source: Author compilation based on Keen and Mansour (2009) and data of International Bureau for Fiscal Documentation and International Monetary Fund.
Note: CIT = corporate income tax. Revenue excludes oil, gas, and mining companies.

These findings are important. It is likely that the incentive to avoid taxes through transfer pricing is based on two considerations. The first is the differential between the tax rates of the countries through which ownership of the goods might pass as part of the transfer pricing supply chain. The greater the differential in tax rates across jurisdictions in the intragroup supply chain, it may be suggested, the greater the prospect that a group of companies will profit from transfer mispricing. The second consideration likely to feature significantly in the decision process on mispricing is the chance that the activity may take place without discovery within the intragroup supply chain. The first issue is considered here; the second, in later parts of this chapter.

The literature that finds evidence for substantial IFFs relating to transfer mispricing also finds evidence that this process is facilitated by the existence of secrecy jurisdictions, most or all of which offer no taxation on foreign source income (Baker 2005; Christian Aid 2008; and so on). As the data noted above show, this 0 rate tax offering has, over time, had a slightly diminishing impact as simple weighted average tax rates have fallen, but, with the rates still hovering at around 27 percent in many of the measures noted, the differential remains large.

The differential is even more significant if comparison is made with the simple weighted average tax rates in Africa. The incentive to tax avoid through transfer mispricing from that continent would appear to be strong, a theme to which we return below.

What does need to be assessed is whether the incentive based on tax rate differentials is sufficient to justify the claimed US$160 billion or more of transfer mispricing that is said to take place each year. Analytical review techniques such as are found in auditing are used here with the objective of testing whether the claimed audit outcome (in this case, that transfer mispricing results in losses to developing countries of US$160 billion a year) is within the plausible range of data outcomes that population information implies may be likely.

It is proposed that, in analytical review terms, the estimates of transfer mispricing would be considered plausible if the total estimated amount of tax lost to transfer mispricing were materially less than the amount of tax lost as measured by the differential between weighted average headline tax rates (which would indicate tax due if corporations were tax compliant) and the tax likely actually to be paid calculated using likely cash paid tax rates, as noted above. In this context, tax compliance is defined as an effort to pay the right amount of tax (but no more) in the right place at the right time, where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

Data on tax rates have already been developed above. The other data needed are as follows:

- A measure of world GDP, because the trade that is transfer mispriced is a proportion of world GDP, and that proportion must be credible
- An indication of corporate profits as a proportion of world GDP, because, ultimately, it is profits that are shifted as a result of transfer mispricing

These data, if combined, will generate the following:

- A measure of worldwide corporate taxable profits
- If weighted by the tax rate data noted above, the measure of worldwide corporate taxable profits will give measures of both the likely tax paid and the tax lost because tax rates weighted by GDP are not paid by major corporations, as noted above

Worldwide GDP was approximately US$61 trillion in 2008.[12] The IFFs that give rise to the estimated tax loss calculated by Christian Aid (2008) amount to between US$850 billion and US$1 trillion a year, representing, in some cases, sums as high as 10 percent of GDP (Kar and Cartwright-Smith 2008). These calculations are based on actual trade data. Illicit flows of this scale are considered plausible for the purposes of this chapter.

As Murphy (2010a) notes, the U.K. tax authorities estimate that 15 percent of total value added tax due on U.K. gross sales and imports in 2008–09 was not collected (HMRC 2010). The part not collected was associated with what might reasonably be described as IFFs using the definitions offered by Kar and Cartwright-Smith (2008). By extrapolation, the total tax loss over the entire U.K. economy was at least 5 percent of GDP in that case. The United Kingdom is considered a well-regulated economy with low levels of tax evasion although the domestic tax authority acknowledges that one-sixth of total gross commercial financial flows are outside the tax system. It is widely accepted that a significant amount of lost value added tax arises as a result of international unrecorded trading flows and illicitly recorded transactions, a matter that has been of considerable concern in the United Kingdom and the rest of the EU for many years. In this circumstance, the estimates of IFFs in developing countries that Kar and Cartwright-Smith (2008) provide appear to be well within the plausible data range based on comparison with alternative reliable information.

Total corporate added value in the U.K. economy represented by the gross operating surplus of corporations is in excess of 20 percent of GDP.[13] In 2008, this gross operating surplus of corporations amounted to £339 billion. Yet, this sum is stated before charges such as interest are offset against profit. Total corporation tax revenues in the same year were £46 billion.[14] On gross value added, this implies an effective tax rate of 13.6 percent. However, Murphy (2008) states that an effective average tax rate of about 22 percent should be anticipated. If this latter rate were applied to tax paid, the gross added value after the interest offset is reduced to £210 billion, a sum that was 14.5 percent of U.K. GDP in 2008.

Data on the same ratio in the United States for 2006, 2007, and 2008 imply that corporate profits were lower, less than 11 percent of GDP and on a downward trend (12.0 percent in 2006, 10.9 percent in 2007, and

9.4 percent in 2008).[15] Nonetheless, this excludes the profits of private companies (which are included in the U.K. data). In this case, one may presume that the two ratios are largely consistent, and a total profit rate of approximately 10 percent of GDP might be considered to be associated with large entities likely to undertake multinational trade. This is probably a reasonable estimate of global corporate profits given that the United Kingdom and the United States are the two largest centers for the location of MNCs in the world. Assuming that this rate may be indicative of worldwide rates, this leads one to suspect that, based on worldwide GDP of US$61 trillion, corporate profits may be conservatively estimated at a total of approximately US$6 trillion in 2008.

We have used secondary sources to check this conclusion. Global data on profits are remarkably difficult to source. However, McKinsey has published a review of the after-tax profits of the top 2,000 companies in the world in 2006 and established that the after-tax earnings of this group in that year were US$3.2 trillion (Dietz, Reibestein, and Walter 2008). Murphy (2008) finds that declared tax rates for companies registered in the United Kingdom and quoted on the stock exchange for that year averaged 25.8 percent (this rate reflecting their worldwide rates and not merely the rate applicable in the United Kingdom), which suggests that the worldwide pretax profits of the McKinsey sample may be US$4.3 trillion. This figure is, of course, somewhat lower than US$6 trillion, but a sample of 2,000 companies is also somewhat lower than the total population of MNCs. There are, for example, more than 2,200 companies quoted in the United Kingdom alone (London Stock Exchange 2010). That 2,000 companies might represent 72 percent of total global profits likely to be of concern does seem plausible, however, and this is considered strong supporting evidence that the estimates of global profits are reasonable.

On this global profit estimate of US$6 trillion, the tax due at weighted average tax rates based on GDP noted above (32.1 percent) might be about US$1.9 trillion. If secrecy jurisdictions and ring-fences are considered, this might fall to a tax figure as low as US$1.2 trillion at a rate of 20.1 percent, as noted above. The rates are selected from among those noted above because, first, it is suggested that the average tax rate weighted by GDP indicates the taxes that would be due if companies

were tax compliant, that is, if they paid the right amount of tax (but no more) in the right place at the right time, where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes and that profits arise where third-party sales (for which GDP is a proxy) occur. Second, the rate, including secrecy jurisdictions and ring-fences, reflects the reality of the tax system that, this chapter notes, MNCs can actually exploit, that is, the rate is used in recognition of the fact that secrecy does allow the relocation of profits and that ring-fences for foreign earnings might be used to apply low tax rates to profits reallocated by transfer mispricing techniques behind the veil of secrecy.

It is plausible that the differential in taxes paid, based on the varying assumptions, of some US$700 billion might include transfer mispricing effects of US$160 billion that have been claimed (Christian Aid 2008). Transfer mispricing abuse would represent 22.8 percent of the tax deferral on this basis, and one may note that, because some of this deferral may be represented as deferred tax provisions in the accounts of MNCs, the actual impact on the tax charge in the accounts of MNCs may be lower than this implies without diminishing the cash loss to developing countries.

A ratio of this proportion allows ample margin for numerous other factors that may reduce declared tax rates, including advanced capital allowances (by far the biggest claimed factor in tax deferral noted in Murphy 2008), nonremittance of profits (perhaps transfer mispricing induced), tax holidays, and so on. If private company profits were to be included in the profit base on which the calculation has been undertaken, the margin for these other factors would obviously be higher still.

What is clear is that these data suggest that US$160 billion in transfer pricing abuse affecting developing counties is plausible within the framework of the world economy given what we know of corporate profits, corporate tax rates, and the opportunities for corporate tax planning.

The risk of being caught

If it is plausible that transfer mispricing of the suggested order may have taken place, we must then ask if the transfer mispricing could have taken place without detection or sanction.

First, this would not happen if all corporations sought to be tax compliant (see above). While some corporations are risk averse, by no means all are.[16] In this case, it is unlikely that all corporations are tax compliant.

The likelihood of noncompliance is increased because of the limited application of the OECD arm's-length pricing rules, which are meant to govern transfer pricing in international trade (see above). For the purposes of this chapter, transfer mispricing is considered a breach of these rules. Because these rules usually only apply if legislation requires or if a DTA is in existence requiring the trade between two jurisdictions to be priced in accordance with these principles, it is likely that transfer mispricing is commonplace.

In EU and OECD countries, which have been used as the basis for much of the published research on transfer mispricing, such DTAs usually exist, as do the resources to monitor the application of these agreements. As a result, it is now often said at tax conferences that mispricing in the trade in goods is rare or almost unknown, although the same is not said of intangibles. Such comments, however, ignore the fact that this is a select sample base that gives little indication of the opportunity for abuse in much of the world.

For example, even a brief review shows clearly that DTAs are notable by their absence in Africa. While South Africa has an impressive range of DTAs, other countries are in a different position.[17] Botswana has 10.[18] Zambia has 17, but most are old, and none has been signed since 1989.[19] The Democratic Republic of Congo has only two DTAs.[20] Angola is far from alone in having no DTAs. The lack of progress in developing new agreements implies that the resources devoted to monitoring the issue are limited in Africa.

Especially since the G-20 summit in April 2009, DTAs have been supplemented by new tax information exchange agreements. These, however, are limited to information exchange issues, as their name implies, and not the regulation of transfer prices (in other words, they exclude standard article 9 of the OECD Model Tax Convention; see OECD 2003). Moreover, as research by Tax Research LLP and the Tax Justice Network (TJN) has shown, as of November 2009, Brazil, China, Japan, India, most of Africa, and almost all developing countries were notable absentees from the list of states that had signed tax information exchange agreements with secrecy jurisdictions (Murphy 2009b). The implication is

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obvious: the places most likely to be subject to transfer mispricing abuse are also the places least likely to enjoy protection from such abuse.

It is accepted that other regulation, such as controlled foreign company rules, might limit the opportunity for such abuse, but, as secondary protection, they do not do so efficiently. First, they do not restore correct pricing between the parties that initiated the trade; so, tax remains inappropriately allocated to jurisdictions given that the application of these rules to transfer mispricing only gives rise to an additional tax payment in the jurisdiction in which the ultimate parent company is located, not in the jurisdiction that lost out initially. Second, the abuse has to be discovered in the parent company jurisdiction. For the reasons noted below, this can be difficult. Consequently, the chance that transfer mispricing will take place without being detected is high.

The Particular Problem in Developing Countries

The issue of enforcing transfer pricing rules in developing countries is particularly acute, as many published reports have shown.[21]

Global Witness has published a report on the operations of Mittal Steel (now Arcelor Mittal) in Liberia. The report provides commentary on the tax provisions of Mittal's mineral development agreement, noting that "probably the single biggest problem with this agreement is that it gives the company [Mittal] complete freedom to set the price of the iron ore, and therefore the basis of the royalty rate" (Global Witness 2006, 7).

There were no restrictions at all in the original agreement between Mittal Steel and Liberia on the transfer prices the company could use. As a result, while there is no suggestion of impropriety, the possibility that transfer mispricing occurred was increased by the absence of any regulation intended to prevent it. In this case and as a direct result of the work of Global Witness, the contract was revised. The changes were noted in a new commentary issued by Global Witness, which reported that "under the amended agreement the [transfer] price is set under the arms length rule, which means that it will be based on the international market price of the ore" (Global Witness 2007, 1).

It would be pleasing to report that all such risks of transfer mispricing have been eliminated so speedily, but the evidence is clear that this is not the case. Problems with transfer mispricing have been found after similar

NGO studies of the extractive industries in many countries. For example, in Zambia, Christian Aid has stated that "in his budget speech in February 2006, the minister of finance estimated that the government was likely to receive less than US$11 million from royalty payments in 2006: that's 0.1 per cent of the value of production in 2005" (Christian Aid 2007, 24). Christian Aid believes that this is in no small part caused by transfer mispricing, which has an impact, in this case, on both royalty payments and declared taxable profits. This is unsurprising. The Investment Act 1993 of Zambia, like its predecessor, the 1991 Investment Act, does not address the issue of transfer pricing (Mwenda 1999). Nor, it seems, do many of the mineral development agreements that have been negotiated in Zambia. This is a situation that may have been addressed by amendments in the Zambian Income Tax Act, passed by parliament in April 2008, which stipulated that royalties are to be calculated based on the average monthly cash price on the London Metal Exchange, *Metal Bulletin*, or any other metals exchange as agreed with the government (Open Society Institute et al. 2009). The impact may be limited, however: most Zambian mineral development agreements have stability clauses exempting them from the effects of any changes in tax law for up to 20 years (Christian Aid 2007).

In the logging sector in the Democratic Republic of Congo, Greenpeace notes as follows:

> Internal Danzer Group documents show in great detail the price fixing arrangements between the Group's Swiss-based trading arm Interholco AG and the parent firm's logging subsidiaries in the DRC and the Republic of the Congo. The DRC-based Siforco sells its wood to Interholco at an official price below the true market value of the wood. The shortfall is made up through unofficial payments into offshore bank accounts in Europe. (Greenpeace 2008, 3)

A review undertaken for this report found no evidence that issues related to transfer pricing were addressed in five mineral development agreements signed from 1994 to 2007 between the government of Tanzania and companies mining gold in Tanzania. Royalty rates were fundamental to anticipated government revenues from royalties and, ultimately, from profits in each case, but on no occasion was the basis specified for setting the price of exports. The tax base on which royalties

were to be charged was thus capable of discretionary determination by the company liable to make the payment of the taxes due. In addition, all the agreements include fiscal stability clauses, and most specify that the basis of the pricing of gold (even though unspecified) should not be unilaterally changed, presumably by the government of Tanzania. For this reason, recent changes to Tanzanian law introducing transfer pricing regulation are likely to have little or no impact in this critical Tanzanian export sector.

The problem has also been found within the Extractive Industries Transparency Initiative. In a review of the first audit of the initiative in Ghana, Murphy (2007, 10) notes that the audit objective to "ascertain the appropriateness of payments made with regards to mineral royalties; ground rent; dividends; taxation on profits and for mineral rights" had not, in the opinion of the reviewer, been fulfilled, largely because of the use of indeterminate prices unrelated to verifiable benchmarks and the use of apparently uncorroborated exchange rates for valuing gold exports, both clear indications that proper transfer pricing controls were not in operation.

The evidence appears to be telling: there is a pattern of transfer pricing abuse or at least the risk of such abuse in developing countries. The evidence from mineral development agreements implies there is no change in the prospects in this area even if legislation to introduce arm's-length pricing rules is enacted because companies in the extractive industries are almost entirely immune to legislative changes affecting the way in which their tax liabilities are computed for periods of up to 30 years after signing mineral development agreements.

It is also important to note another key feature emphasized by this work: the transfer pricing abuse in these cases is highly unlikely to be motivated by taxes on corporate profits alone. The abuse is likely to extend to royalties, sales and purchase taxes, dividends, abuse of profit-sharing agreements, and more. The incentives to abuse are high, indeed; the consequences of not tackling the issue are considerable; and the prospects for tackling the abuse within current legislative and contractual constraints are not good.

Even if arm's-length transfer pricing rules do exist in developing countries, there appear to be almost insurmountable problems in enforcing them. As one of the rare cases of suggested transfer pricing abuse

ever brought to court in Africa has shown (*Unilever Kenya Ltd v. Commissioners of Income Tax*, Kenya Income Tax Appeal 753, 2003), the absence of the accounts of the related party with whom trade was being undertaken in the destination jurisdiction is a significant cause of the failure to prove that profit was being shifted through the transfer mispricing of goods; this is what the Kenyan authorities were seeking to prove had occurred using the OECD arm's-length principle. Although the accounts in question were necessarily available to the group of companies the Kenyan subsidiary of which made the appeal in this case, they were not made available to the court. It is likely that the withholding of this accounting data, albeit entirely legal, had a material impact on the resulting decision of the court in Kenya.

Secrecy prevented the proper determination of a transfer pricing issue in this case, whether rightly or wrongly. This is a recurring theme of work in this area, as is the persistence of the assertion that developing countries are particularly vulnerable to the effects of secrecy. If this is the case, it is important that the mechanisms for creating this secrecy that permits transfer mispricing to take place undetected, unchallenged, or uncorrected be considered. Unless it can be shown that corporations can make use of secrecy to achieve this outcome, then it remains implausible that transfer mispricing of the alleged scale takes place. If, in contrast, significant secrecy is available to corporations, then corporations have the opportunity to transfer misprice, as some believe is taking place.

How Multinational Corporations Exploit Secrecy

The modern MNC is a complex entity. This is not the place to explore all aspects of the nature of the MNC or the motivations for creating some of the structures MNCs use, but, without consideration of the interaction of the corporation, jurisdictions, corporate law, and tax law, testing the proposition that transfer mispricing can take place within MNCs and be hidden from view within the accounts and financial statements of MNCs is not possible.

The MNC is almost invariably headed by a single company, the parent entity, which is almost always a limited liability corporation. The parent entity comprises a number of other, usually similar limited liability corporations spread over one or more other jurisdictions. For example, in

the course of researching this report, we noted that United Kingdom–based BP plc has more than 3,000 subsidiaries in over 150 jurisdictions.

Subsidiaries need not be limited liability corporations. As noted in International Accounting Standard 27 (IAS 27, 2009), a subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).[22] Subsidiaries can therefore also be limited liability partnerships in any form, whether trusts, charities, or other arrangements, but limited liability corporations are the most common by far. The key is that the parent company controls the subsidiary. Control is widely defined by IAS 27, but most commonly means that the parent has direct or indirect control of a majority of the equity shares.

However control is established, if a parent entity governed by the IFRSs (which, in this respect, operate almost identically to the U.S. Generally Accepted Accounting Principles) has subsidiary entities, then IAS 27 requires that consolidated accounts and financial statements be prepared. These are the financial statements of a group of entities presented as if they were those of a single economic entity.

It is immediately apparent that, within this requirement, there is an obvious conflict of interest. The parent entity of such a group may be required to present the group's accounts as if the group were a single entity, and, yet, in practice, the group may be made up of thousands of entities that are under the control, but not necessarily the sole ownership of the parent entity. Thus, in substance, each entity within the MNC may remain legally distinct, and each may be subject to the rules of accounting, taxation, and disclosure of the jurisdiction in which it operates. In a real sense, each subsidiary is therefore without obligation to the other members of the group, bar the duty the directors and managers of the entity may owe to the owners to whom they report under the law of the jurisdiction in which the entity is incorporated, and this duty varies widely from place to place.

Curiously, according to the one nearly constant assumption in company law, the shareholders and the owner do not have the right to manage the entity: that right belongs to the directors. Of course, the shareholders may have the right to appoint the directors, but, it is important to note, the assumption underpinning group accounts pierces the veil of incorporation that, in turn, underpins the notion of the limited liability

entity. The dichotomy is that the assumption accomplishes this in the effort to reinforce the division inherent in the act of incorporation through the presentation of the group as one undertaking distinct from the owners, who obtain only the limited information the directors may wish to supply, subject to legal constraints.

The inherent conflict in reporting results is exacerbated by a number of other factors. First, the definition of control used for accounting may be different from the definition used by some jurisdictions for tax. So, some entities that are within the group for tax purposes in some locations may not be within the group in other locations. For example, tax may require 75 percent control, while accounting requires 50.01 percent in most cases. Therefore, entities that, for accounting purposes, may be related parties requiring inclusion in a common set of consolidated accounts and financial statements may not be so treated for transfer pricing purposes.

Second, note that some entities are deliberately structured to exploit the rules on consolidated financial reporting. In particular, the financial services industry has become expert at creating orphan entities. These are companies that are created by a parent organization and that are deliberately structured by the parent entity so that they are off the balance sheet; thus, the assets or liabilities that the orphans own are excluded from consolidation in the parent entity's accounts and financial statements, as are the results of the trading of the orphans.

A common way to engineer this outcome is to create a company to which are transferred the off–balance sheet assets and liabilities the parent entity wishes to hide from view. The new entity is owned by a charitable trust, for example. As such, it is not considered to be under the ownership or control of the parent entity. This is why it is described as an orphan; it has become parentless, although it is utterly dependent on the parent entity.

These entities are hard to spot, but commonplace. While the entities are used to exclude liabilities from accounts, the rules that permit this will, in most cases, also allow them to be used for transfer mispricing, which may pass undetected, subject to the caveat that the proceeds must then be used for purposes that the group may wish to keep at quasi-arm's length. This purpose may be fraudulent.

Third, it is widely assumed that consolidated accounts and financial statements are created by adding together all the accounts of the individual entities that make up the group and then eliminating all the intragroup transactions and balances. This is a simplistic, but not wholly inappropriate view of what should happen. The reality is that MNCs can deliberately obscure the relationship between the underlying accounts and financial statements of the subsidiary companies and the group accounts in ways that make it almost impossible to detect what is really happening within the group.

The first method to achieve this is the use of different accounting year-end dates for group companies. IAS 27 (section 26) says this should not occur and that any differences should be explained, but the reality is (as the author has frequently witnessed) that noncoterminous year-ends are commonplace and almost never disclosed or commented upon. If noncoterminous year-ends are used, transfer mispricing may then be relied on to shift profits (and losses) around the group almost at liberty and almost entirely undetected.

Next, nonstandard accounting policies may be used in different places to recognize transactions even though, according to IAS 27, this should not occur. This is now commonplace. The parent company might account using IFRSs, but local entities may well account using local Generally Accepted Accounting Principles, and there is nothing to prevent this. Some significant transactions have different tax treatments depending on the accounting standards used. There are, for example, conflicts between the United Kingdom and the International Accounting Standards on financial derivatives for tax purposes. These differences and conflicts have been exploited by international banks.

In addition, entries can be made in the consolidated accounts alone, without ever appearing anywhere in any of the accounts of the underlying entities. In principle, this should not occur because the accounts can then be said not to reflect the underlying books and records of the MNC that is publishing them, but, in practice, if the entries are considered a nonmaterial adjustment in the assessment from the point of view of the user of the financial statements, which both the International Accounting Standards Board and the U.S. Federal Accounting Standards Board define as "a provider of capital to the company," then no auditor is likely

to object. This can, however, disguise radically different presentations of profit on trades between related undertakings in group consolidated accounts and financial statements and individual entity accounts and financial statements, especially if the tax implications are considered, so that the benefit may be hidden from view in the accounts of the group as a whole. Interview-based evidence indicates that this practice may be commonplace. It will never be discovered by tax authorities because it is the accounts and financial statements of the individual subsidiary entities that are used to determine tax liabilities in each jurisdiction in which these entities trade. The consolidated accounts and financial statements are deemed to have no tax interest to tax authorities (although it is not clear that this is true), and, as such, in jurisdictions such as the United Kingdom, the tax authorities are not entitled to ask questions about the entries that make up these published accounts.

This last point is, perhaps, of the greatest significance because the exact entries that are eliminated from view when the consolidated accounts and financial statements are prepared are those same transactions that will always have the potential to give rise to transfer pricing disputes. For this reason, the most useful evidence that consolidated accounts and financial statements could provide to tax authorities—the data relating to transfer pricing issues, which are the data on the "most contentious issue in tax," according to a poll of U.S. tax directors in 2007—is denied to the tax authorities who need it.[23]

This omission is exacerbated by a number of other practices, all endorsed by the IFRSs and all of which make it easier to hide transfer pricing abuse. First, in the individual accounts and financial statements of the subsidiaries that make up an MNC, it would seem obvious that the transactions with other group companies should be highlighted if only to indicate that they will disappear upon consolidation. This is theoretically required by another International Accounting Standard, IAS 24, on related-party transactions. Broadly speaking, IAS 24 (section 9) defines a party as related to an entity if one party directly or indirectly controls the other, but associates, joint venturers, and some other arrangements are also included in the definition. IAS 24 defines a related-party transaction as a transfer of resources, services, or obligations between the related parties regardless of whether a price is charged (section 9). As a result, it would seem that all transactions among group companies must be dis-

closed in a group's financial statements because a long list of disclosable transactions of this sort is included in the standard.

Unfortunately, the prospect of disclosure that this requirement creates is then dashed. IAS 24 proceeds to state that, while the disclosure must be made separately for the parent company, subsidiaries, and other identified categories of related parties, the information within each such category "may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of the related party transactions on the financial statements of the company." As a result, all trading by a subsidiary with all other subsidiaries can be aggregated into one number in most cases, and no indication need be given of the other party in a trade, what has been traded, or on what terms and where the other side of the transaction might be recorded.

The result is obvious: the accounts and financial statements end up providing no meaningful information at all on transfer pricing issues. The information is excluded from consolidated accounts and financial statements because related-party trades between parents and their subsidiaries and between fellow subsidiaries are always excluded from these accounts, while the disclosure requirement on individual group members is so limited that forming a view on transfer pricing is almost impossible in most cases: it is rare for the other party to any transaction to be disclosed, especially within a large and complex group.

This might be thought an accident. Regrettably it is not, as IAS 24 makes clear. In the latest version of the standard, introductory note IN7 states that "discussions [in the standard] on the pricing of transactions and related disclosures between related parties have been removed because the Standard does not apply to the measurement of related party transactions."

This is an extraordinary statement. Accounts prepared under IFRSs and their U.S. equivalents are the basis of corporate taxation in a great many countries in the world, but the International Accounting Standard that is responsible for their promulgation says that it is not the purpose of the standard to assist in the measurement of matters related to transfer pricing. Moreover, it offers no suggestion on how such matters should be considered or measured.

What is clear is that it is not the intent in the standards that the only other part of the IFRS environment that might provide information on

the issue—IFRS 8, on segment—do so. IFRS 8, by default, usually only applies to companies quoted on a stock exchange in a jurisdiction that has adopted IFRSs (as all countries in the EU have done, for example). It defines an operating segment as a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses;
- the operating results of which are reviewed regularly by the entity's chief operating decision maker so as to make decisions about the resources to be allocated to the segment and assess its performance; and
- for which discrete financial information is available.

IFRS 8 requires an entity to report financial and descriptive information about the entity's reportable segments. These are operating segments or aggregations of operating segments that account for more than 10 percent of the revenues, profits, or assets of the entity. Smaller segments are combined until ones of this size are created, supposedly to reduce information overload. In practice, this might, of course, hide necessary detail.

Required disclosure by reportable segments targets trading data, including profit and loss, assets and liabilities, and limited geographical analysis. Such a summary does not, however, show the true level of problems inherent within IFRS 8, which also allows segment data to be published using accounting rules that are not the same as those used in the rest of the accounts and financial statements, meaning, as a result, that segment data may be formulated in a way harmful to the appraisal of transfer mispricing. In addition, IFRS 8 does not require that segments cover all of the MNC's activities, meaning some information may be omitted, providing more opportunity for transfer mispricing to be hidden from view.

As a consequence, considerable support has developed for an alternative form of segment accounting called country-by-country reporting, created by the author of this report (Murphy 2009a). Country-by-country reporting would require an MNC to disclose the name of each country in which it operates and the names of all its companies trading in each country in which it operates. Currently, these data are usually unavailable. Country-by-country reporting would then require publica-

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tion of a full profit and loss account for each country in which the MNC operates, plus limited cash flow and balance sheet information. Radically, the profit and loss account would break down turnover between turnover involving third parties and turnover involving group entities. Costs of sale, overhead, and finance costs would have to be broken down in the same way, while a full tax note would be required for each country, as is presently necessary for IFRSs.

In addition, if the company operates within the extractive industries, one would also expect to see all those benefits paid to the government of each country in which the MNC operates broken down across the categories of reporting required in the Extractive Industries Transparency Initiative.

As Murphy (2009a, 18) notes, "country-by-country reporting does not [stop transfer mispricing]. What it does do is provide data that . . . tax departments . . . can use to assess the likely risk that exists within the accounts of a multinational corporation. They can do this by

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- "Assessing the likelihood of risk within the group structure;
- "Reviewing the overall allocation of profits to countries within the group to see if there is indication of systematic bias towards low-tax jurisdictions;
- "Assessing whether the volume and flows of intragroup trading disclosed by country-by-country reporting suggests that this outcome is achieved as a result of mispricing of that trade;
- "Using that information to assess where that abuse is most likely to occur so that an appropriate challenge can be raised."

So far, the International Accounting Standards Board has only indicated willingness to consider this issue with regard to the extractive industries, and current indications are that, despite the considerable lobbying, there is little prospect of an advance on this issue. The conclusion is inescapable: as one board member said when the issue of country-by-country reporting was being discussed by the International Accounting Standards Board, "this looks like it deals with the issue of transfer pricing, and we do not want to go there."[24] The comment is succinct and neatly summarizes the design of current accounting standards, which seem purpose-made to hide the subject of transfer pricing from view.

The Role of Secrecy Jurisdictions

The literature that alleges substantial transfer mispricing abuse by MNCs also finds that tax havens play a significant role in the process. The term tax haven is, however, so widely misunderstood that this chapter does not use it, preferring instead to use the term secrecy jurisdiction. For a more detailed consideration of the term, the nature of a secrecy jurisdiction, and the economic significance in the matters under consideration here, see chapter 11 in this volume. A list of the places currently considered significant secrecy jurisdictions is available in table 9A.4.[25]

The term secrecy jurisdiction is considered more appropriate for the purposes of the current analysis because, although the process of transfer mispricing to which this chapter refers seeks to secure a tax advantage (by way of reduced tax payment) for those who pursue the activity, this advantage is not normally available unless the abuse giving rise to the advantage—the artificial relocation of activities to one or more secrecy jurisdictions—can be hidden from view behind a veil of secrecy. Secrecy jurisdiction opacity is often, of course, linked to low tax rates (see above).

The combination of low tax rates and secrecy has obvious attractions for those seeking to transfer misprice. However, to demonstrate whether or not MNCs actually use secrecy jurisdictions and which ones they might use if they do, TJN has coordinated, under the direction of the author of this chapter, a survey of the locations of MNC subsidiaries, paying particular attention to the secrecy jurisdictions TJN has identified. The results of the study by the U.S. Government Accountability Office of December 2008 (GAO 2008), "Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions," have been used as part of the survey. Because the U.S. survey excludes data on the Netherlands, the United Kingdom, and the United States, these locations have also been excluded from the TJN survey. Austria (for practical rather than methodological reasons), Belgium, and Madeira (because of difficulties in isolating data independently from Portugal) have also been excluded.

The total sample of MNCs surveyed is shown in table 9.4.

It should, however, be noted that the data selection has been pragmatic: the U.K. data should have been the entire FTSE 100, that is, the 100 largest companies in the United Kingdom, designed to match the U.S.

Table 9.4. Multinational Corporations Surveyed by the Tax Justice Network
number

Country	MNCs sampled
France	39
Netherlands	23
United Kingdom	33
United States	100
Germany	28
Switzerland	20
Total	243

Source: Mapping Financial Secrecy (database), Tax Justice Network, London, http://www.secrecyjurisdictions.com/index.php (accessed December 12, 2009).

sample. In practice, although all United Kingdom–quoted companies are legally required to publish the names, places of incorporation, and percentage of the holdings for all their subsidiary companies annually either in their audited accounts and financial statements or as an appendix to their annual declaration made to the U.K. Registrar of Companies, only 33 of the FTSE 100 companies did so. Enquiries found that no company had ever been prosecuted for failing to file this information. It is a curious example of the United Kingdom's opacity (see table A9.5).[26]

It should also be noted that substantial problems were encountered with all other samples. The French data undoubtedly underreport the number of subsidiaries because they only relate to principal subsidiaries, not all subsidiaries. German companies do not always make the distinction between subsidiaries and associates clear. The Dutch and Swiss data have been taken from databases, not original documentation, which implies that there are inconsistencies in approach, particularly about whether dormant subsidiaries are counted or not, and so on. All such issues do, however, reveal one consistent theme: it is immensely difficult to determine the composition of an MNC.

Detailed analysis of the regulatory requirements of the 60 secrecy jurisdictions surveyed by TJN highlights the issues. Of the 60 jurisdictions surveyed, accounts of companies were available on easily accessible public record in only six.[27]

Table 9.5. Secrecy Jurisdiction Locations of Multinational Corporation Subsidiaries
number

Rank	Secrecy jurisdiction	MNC subsidiaries
1	Cayman Islands	1,130
2	Ireland	920
3	Luxembourg	824
4	Switzerland	771
5	Hong Kong SAR, China	737
6	Singapore	661
7	Bermuda	483
8	Jersey	414
9	Hungary	252
10	British Virgin Islands	244
11	Malaysia (Labuan)	177
12	Mauritius	169
13	Bahamas, The	156
14	Guernsey	151
15	Philippines	126
16	Panama	125
17	Isle of Man	99
18	Costa Rica	85
19	Cyprus	69
20	Netherlands Antilles	68
21	Uruguay	67
22	Malta	60
23	United Arab Emirates (Dubai)	58
24	Israel	56
25	Gibraltar	54
26	Barbados	51
27	Latvia	40
28	U.S. Virgin Islands	37
29	Monaco	35
30	Liechtenstein	32

Source: Mapping Financial Secrecy (database), Tax Justice Network, London, http://www.secrecyjurisdictions.com/index.php (accessed December 12, 2009).

The situation was worse for the beneficial (as opposed to nominal) ownership information on public record. Only Monaco requires that these data be available. In all other cases, nominee ownership may be recorded, or there is simply no requirement to record data on public record at all.[28]

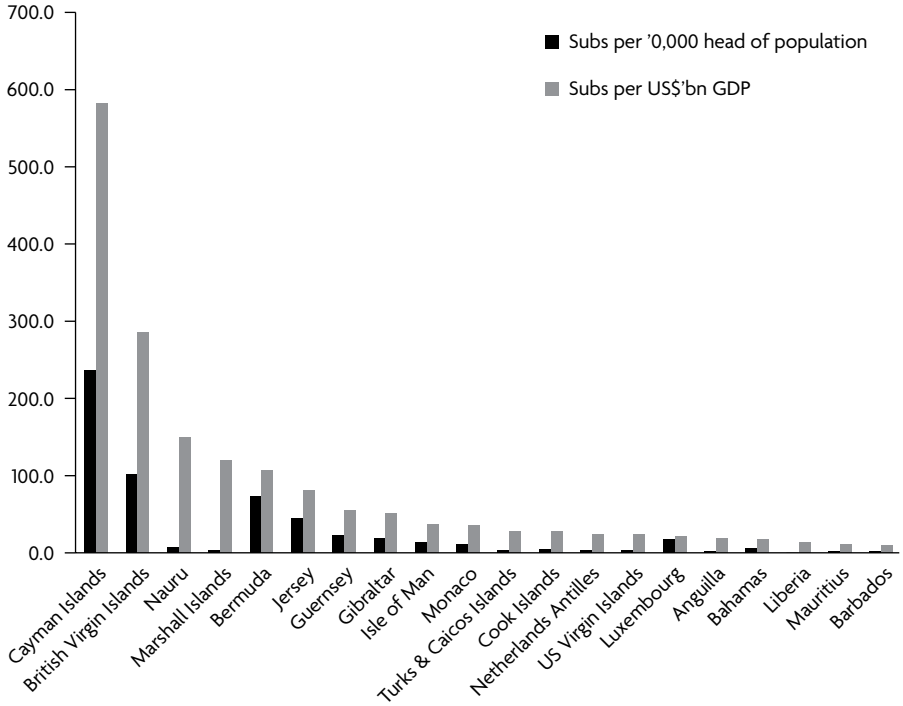
It is readily apparent, as a consequence, that, unless data are required from MNCs on the companies making up or not making up their group and the operations of each, as shown by the audited accounts, then the current legal requirements for data registration within secrecy jurisdictions ensure that the information required to assist in the appraisal of MNC activities, including those relating to transfer mispricing, will simply be unavailable to most people and, quite possibly, to many tax authorities if that is the MNC's wish, as it will be if the MNC is seeking to hide transfer mispricing activity.

This would not be an issue if MNCs did not use secrecy jurisdictions. The reality is that they do use secrecy jurisdictions extensively. Of the European and U.S. samples, 97.2 and 84 percent, respectively, had secrecy jurisdiction subsidiaries as defined by the TJN. Table 9.5 indicates the number of subsidiaries by location according to the TJN survey. (Data on the 24 additional, smaller jurisdictions have been ignored; these jurisdictions are immaterial for the purposes of this chapter.)

It is readily apparent that some locations stand out, but the data make a lot more sense if they are plotted against two control variables: population and GDP (figure 9.4).

The data in figure 9.4 are ranked by the number of subsidiaries by GDP in billions of U.S. dollars. In most cases, the correlation with a ranking by the number of subsidiaries per head of population is clear. These weighted data give a much better view of the relative importance of these secrecy locations. It is apparent that some show extraordinary amounts of activity relative to their size. There is only one explanation for this: the secrecy jurisdictions are not creating entities for use by the local population, but, as the definition of these jurisdictions in this chapter suggests is likely, for the use of people resident elsewhere. The companies that are registered in these jurisdictions do little or nothing in these locations.

Figure 9.4. Top 20 Subsidiaries by Secrecy Jurisdiction, Population, and GDP



Source: Mapping Financial Secrecy (database), Tax Justice Network, London, http://www.secrecyjurisdictions.com/index.php (accessed December 12, 2009)

That this must be true is indicated by the number of subsidiaries active in financial services as a proportion of the total working population in the secrecy jurisdictions. As TJN has noted, this exceeds 20 percent in Cayman Islands, Guernsey, Isle of Man, and Jersey and 10 percent in Bermuda, Liechtenstein, and Luxembourg.[29] Financial service sectors of this size crowd out the possibility of any other significant economic activity taking place. The overlap between this list (figure 9.4) and the locations with the most MNC subsidiaries (table 9.5) is obvious, and the implication is clear: these locations do not create value. Their sole raison d'être is the provision of corporate and financial service structures that may record value, but do not generate it. Of course, one way in which this value may be relocated into these places is through transfer mispricing.

The existence of the Big Four firms of accountants—PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young, and KPMG—in many secrecy jurisdictions in which their location cannot possibly be justified solely by the needs of the local populations reinforces this view. As Murphy (2010b) shows, the Big Four firms are significantly overrepresented in small secrecy jurisdictions (those with less than 1 million population) compared with other locations of this size (see table 9A.6).[30] As he also shows, these locations of the Big Four have an average GDP per head that is approximately four times greater than the average GDP in similar locations in which the Big Four are not present. Of course, cause and effect cannot be proven based on this circumstantial evidence, but the possibility exists, especially in the smallest of such locations, that the income in question is not earned in these places, but is transferred in through transfer mispricing, and, in that case, the Big Four firms, as Murphy suggests, facilitate the structures that allow the transfer mispricing to occur.

Conclusion

This chapter has sought, first, to test the credibility of the claim that that at least US$160 billion a year may be lost by developing countries as a result of transfer mispricing by MNCs.

Second, it has sought to demonstrate that developing countries and, particularly, the extractive industries may be especially prone to this abuse.

Third, it has considered whether this sum may be hidden from view within the accounts or financial statements of the MNCs that may be perpetrating the mispricing.

Fourth, it has explored the possibility that these MNCs may use secrecy jurisdictions to assist in hiding these transactions from view.

As the chapter indicates, the incentive to transfer misprice is great. This is because, first, the differential in effective tax rates between the jurisdictions in potential supply chains is higher than the existing literature on tax rates suggests would normally be the case. Second, it is because the structure of international tax regulation at present suggests that the chance of detection of transfer mispricing is low.

The chapter then shows that the risk that transfer mispricing may go undetected within the extractive industries that supply much of the external earning capacity of many developing countries is great. As the chapter also notes, transfer mispricing in this sector is unlikely to be motivated by a desire to avoid taxes on corporate profits alone. The abuse is likely to extend to royalties, sales and purchase taxes, dividends, abuse of profit-sharing agreements, and more. The incentives to abuse for all these reasons are substantial, and the consequence of not tackling the issue considerable, but, as the chapter shows, the prospects of tackling the issue are limited given the current legislative and contractual constraints.

The chapter also reviews a number of IFRSs, in particular the standards addressing consolidated accounts and financial statements, related-party transactions, and segment reporting: the three standards most likely to relate to disclosure of intragroup trade within the accounts of MNCs. The analysis shows that these standards are not designed to and are not capable of leading to the disclosure of these transactions and the associated transfer pricing. It proposes that this failure may be intentional.

The chapter defines secrecy jurisdiction and argues that secrecy jurisdictions are deliberate constructs. Secrecy jurisdictions are used disproportionately by MNCs as measured relative to local populations and GDP. In the secrecy jurisdictions most popular with the MNCs, there is little prospect of any real added value arising because, as the chapter shows, the economies of these secrecy jurisdictions are largely dedicated to the supply of financial services, part of which activity is administered by the MNC subsidiaries. This pattern of use does, however, accord with the proposed definition of a secrecy jurisdiction, suggesting that the purpose of these jurisdictions is to disguise the true nature of activity undertaken elsewhere so that compliance with the regulations of others states can be avoided or evaded. Transfer mispricing may be only one abusive activity that may be occurring.

What overall conclusions may one draw from this evidence? The following conclusions are proposed.

First, it is apparent that there is a stronger incentive to transfer misprice than the existing literature has suggested. Second, developing countries are particularly susceptible to this activity. Third, this activity can be hidden from view in accounts. Fourth, secrecy jurisdictions pro-

vide an additional layer of opacity to disguise this activity. Fifth, the combination of the secrecy inherent in accounting rules and secrecy jurisdiction legislation provides a deep opacity that limits the possibility of discovering transfer mispricing activity. As a result, the chapter finds that transfer mispricing may be taking place undetected.

In this case, is it also plausible that the quantum of the loss to developing countries may be as much as US$160 billion per annum? As noted in the chapter, this seems to be quite plausible on the basis of data verified from a variety of sources and therefore considered a credible basis for the analytical review techniques common in auditing methodology.

Thus, on the basis of the methodologies noted, the chapter concludes that substantial transfer mispricing by major corporations contributing to a loss of at least US$160 billion a year to developing countries is plausible in the context of the total likely corporate profits earned worldwide in a year.

Notes

1. Transfer mispricing occurs if two or more entities under common control that are tra ax advantage that would not be available to third parties trading in the same goods or services across the same borders.
2. The arm's-length principle is the international standard that OECD member countries have agreed should be used to determine transfer prices for tax purposes. It is set forth in article 9 of the OECD Model Tax Convention, as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly" (Centre for Tax Policy and Administration, "Annex 3: Glossary," OECD, Paris, http://www.oecd.org/document/41/0,3343,en_2649_33753_37685737_1_1_1_1,00.html (accessed October 13, 2011). See also chapter 7.
3. IFFs are defined by Kar and Cartwright-Smith (2008) as "the proceeds from both illicit activities such as corruption (the bribery and embezzlement of national wealth), criminal activity, and the proceeds of licit business that become illicit when transported across borders in contravention of applicable laws and regulatory frameworks (most commonly in order to evade payment of taxes)."
4. Secrecy jurisdictions intentionally create regulation for the primary benefit and use of nonresidents in the geographical domain. The jurisdiction regulation is designed to undermine the legislation or regulations of another jurisdiction.

The jurisdictions create a deliberate, legally backed veil of secrecy that ensures that those from outside who use the jurisdiction regulations cannot be identified by others.

5. See World Factbook (database), Central Intelligence Agency, Washington, DC, https://www.cia.gov/library/publications/the-world-factbook/.
6. Jurisdiction Centre (database), OCRA Worldwide, Isle of Man, United Kingdom, http://www.ocra.com/jurisdictions/index.asp.

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7. The table may be found on the website of this volume, http://www.xx.
8. The table may be found on the website of this volume, http://www.xx.
9. Devereux, Lockwood, and Redoano (2003) are typical of the other surveys in that they also entirely ignore the tax haven–secrecy jurisdiction issue.
10 Jurisdiction Centre (database), OCRA Worldwide, Isle of Man, United Kingdom, http://www.ocra.com/jurisdictions/index.asp.
11. The table may be found on the website of this volume, http://www.xx.
12. Based on International Monetary Fund–World Bank data summarized at http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal) (accessed on March 3, 2010). In each case, the data are in the range of US$60 trillion to US$61 trillion. Original sources are linked through the website noted.
13. Data of the U.K. Office for National Statistics.
14. HMRC (HM Revenue & Customs), 2009, "HM Revenue and Customs Annual Receipts," data sheet, December, London, http://www.hmrc.gov.uk/stats/tax_receipts/table1-2.pdf.
15. Data of the Bureau of Economic Analysis, U.S. Department of Commerce.
16. Anecdotal evidence based on conversations with high-ranking officials of HM Revenue & Customs leads us to believe that approximately 35 percent of all large companies in the United Kingdom are considered to have little appetite for taxation risk, while at least 40 percent are considered to have exposed themselves to high risk in the management of their taxation affairs.
17. See South African Revenue Service, http://www.sars.gov.za/home.asp?pid=3906 (accessed August 17, 2009).
18. Lowtax, Global Tax and Business Portal, "Botswana: Double Tax Treaties." http://www.lowtax.net/lowtax/html/botswana/jbo2tax.html (accessed August 17, 2009).
19. Zambia Revenue Authority, "Tax Treaties." http://www.zra.org.zm/Tax_Treaties_Agreemnet.php (accessed August 17, 2009).
20. See United Nations Conference on Trade and Development, http://www.unctad.org/sections/dite_pcbb/docs/dtt_Congo_DR.PDF.
21. It is appropriate to note that the author of this chapter has acted as adviser on transfer pricing or contractual issues to the authors of most of the reports referred to in this section.
22. See Standards (IFRSs) (database), International Accounting Standards Board, London, http://www.ifrs.org/IFRSs/IFRS.htm.

23. For the citation, see "US Tax Directors' Poll: TP Is Most Contentious Issue," *TP Week*, December 12, 2007, http://www.tpweek.com/Article.aspx?ArticleID=1786798.
24. Reported by Richard Murphy, September 2006.
25. The table may be found on the website of this volume, http://www.xx.
26. The table may be found on the website of this volume, http://www.xx.
27. See Mapping Financial Secrecy (database), Tax Justice Network, London, http://www.secrecyjurisdictions.com/index.php (accessed December 12, 2009).
28. See Mapping Financial Secrecy (database), Tax Justice Network, London, http://www.secrecyjurisdictions.com/index.php (accessed December 12, 2009).
29. See Mapping Financial Secrecy (database), Tax Justice Network, London, http://www.secrecyjurisdictions.com/index.php (accessed December 16, 2009).
30. The table may be found on the website of this volume, http://www.xx.

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