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EMERGING ISSUES IN TAX AND REGULATION

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Introduction

The decade following the 2007-2008 had been arguably the most significant period in the international battle against tax evasion and avoidance. Following the mix successes of previous efforts of the OECD at combatting harmful tax competition (OECD, 1998)and the introduction of tax information exchange agreements (TIEA) (Lang et al., 2015), the OECD is developing a system of Common Reporting Standards (CRS) in support of Automatic Exchange Agreements. The OECD has launched its ambitious base erosion and profit shirting program (BEPs) (OECD, 2013) which includes, among other action point, country by country reporting. The US introduced its wide-ranging set of rules under FATCA (McGill, 2013), followed by Europeans versions of 'mini-FATCAs' (Lang et al., 2018). The EU has commissioned a number of in-depth studies in aggressive tax avoidance (ATP), schemes with the aim of further tightening regulation (TAXUD, 2018).

These regulatory efforts are not taking place in a vacuum. For every action there is a reaction, and every new set of national and international rules and regulations are likely to stimulate whole series of adaptions, innovation and niche seeking behaviour on the part of various stakeholders. Sometimes the response of actors affected by regulations are direct: they will seek to marshal political forces to resist the introduction of new rules. Often response is more subtle, taking the form of innovation, niches, rule arbitrage and even sector hoping. Our working assumption is that irrespective of the current flurry of regulatory efforts, the 'demand' for avoidance tax is unlikely to have subsided. On the one contrary, the number of HNWI have increased dramatically during the past decade; the corporate sector is as centralised as ever, with two of the largest firms in the world in capitalization, Apple and Amazon, surpassing if only briefly the US$1 trillion mark. There is no evidence for the decline in what is now described as the 'enablers industry' that consists of range of offshore financial centres and accounting and legal firms, onshore and offshore.

The interplay of various stakeholders, each innovating and adapting to changing circumstances, ensures that complex regulatory environments, such as the European fiscal regulatory environment are like organisms, evolve and adapt typically in unanticipated directions. Rarely if ever, however, it is possible to anticipate reaction to a new regulatory environment. In seeking to anticipate likely response to the new fiscal regulations, we assumed that existing opportunities for arbitrage, or 'pressure points' would be ceased upon by stakeholders. We focused on three potential systemic 'pressure points' that were likely bear the brunt of the countermeasures to the new regulatory environment.

- We knew from recent US studies that sophisticated financial instruments such as derivatives and swaps are used extensively as techniques of tax avoidance as well. Existing gulf, even a chasm, between fiscal and monetary realms, in academia and among the regulators is an opportunity. In light of tightening regulations, could finance become the new sphere of avoidance?
- Financial innovation and regulation have historically co-evolved, with technological and financial innovation usually outpacing the regulatory cycle. At present, a vast gap between developments in the industry and the regulatory sphere has been created by the rapidly growing financial technology (Fintech) sector. What is the likelihood that Fintech will not only transform the financial sector, but also generate a whole new world of tax avoidance and evasion not addressed by regulators?
- The new rules and regulations of transparency relies on certain technologies. For instance, the implementation of a common reporting standards and automatic

exchange agreements would have to rely on a technology not yet finalised in 2016, known as Legal Entity Identifier (LEI). LEI is exactly the sort of 'technical' initiative that we believed might be subject to political manoeuvres and gaming, with the possible result that some of the infrastructure of transparency may be less effective. Could vested interest undermine the techniques rendering CSR far less effective than anticipated

Finance

Post-ante investigations into the financial meltdown of 2007-9 revealed that banks, including largest financial houses in the US, have been developing and employing sophisticated financial instruments in facilitating tax evasion and avoidance. In 2011, the Government Accountability Office (GAO) in the US released the first, and so far the only, in-depth analysis of the use and potential abuse of financial instruments for tax avoidance by the US corporate sector. GAO established that financial derivatives are the main tools multinational corporations (MNCs) employ for tax noncompliance purposes (GAO, 2011). The majority of market actors we interviewed tend to agree with GAO's findings, believing that sophisticated financial instruments such as swaps and derivative contracts, are the biggest ticket item of tax abuse.

In light of increasingly recognised importance of financial innovation in enabling tax abuse, we following questions:

- Whether derivatives and other financial instruments are used as techniques of tax avoidance and evasion by the European banking and corporate sectors as well.
- If yes, whether there might be material differences in the type, range or mix of techniques of financial engineering that are used by the EU banking and corporate sector, due to divergent regulatory environment between the US and EU.
- Whether the OECD initiative on Base Erosion and Profit Shifting (BEPS) or more recent EU-funded research into sophisticated aggressive tax avoidance schemes is tackling the problem of tax abuse via sophisticated financial engineering.
- Whether EU post-crisis derivatives regulations are (a) intended, or (b) likely to address some of the loopholes used of financial engineering enabled tax avoidance and evasion.
- Whether rapidly emerging new financial technologies generate any additional opportunities for tax evasion or avoidance.

Our conclusions can be summarised as follows:

- There are inherent characteristics pertaining to financial innovation, specifically concerning the use of derivatives that make these instruments particularly fertile for engaging in aggressive tax planning practices. This is due to the fact that derivatives can represent any economic position whilst changing its transactional form. Typically, derivatives can be executed in such a manner that the contract falls under a different tax regulation than the one the original economic position called for. This pliability, together with the notorious complexity and obscurity of derivative transactions, makes these instruments ideally suited to be used in tax abusive strategies, with minimum traceability and relative impunity. In this respect, the situation in the EU is not different from the US.
- There have been a number of important academic and high-profile political investigations of the use of options and swaps in the US context. Neither in academia,

nor in the policy domains, have there been an equivalent set of studies in Europe. In fact, tax optimisation and most specifically, tax deferral, continue to be the ultimate targets of the deployment of sophisticated financial instruments by European firms and banks.

- Initiatives like OECD's Base Erosion and Profit Shifting (BEPS) and EU's Aggressive Tax Planning Indicators (ATPI) are relatively comprehensive in their aims to tackle some of the pitfalls of MNEs straddling heterogeneous national taxation systems; yet they do not focus on the opportunities created by financial engineering with regards to tax avoidance or evasion.
- The reporting systems of derivatives in the US and in Europe are inconsistent, asymmetric, and indeterminate, creating a fertile ground for arbitrage. The situation appears to be worse in Europe due to the discretion afforded by the EU to individual Member States in the taxation of financial instruments reported by EU companies.
- The new, post-2009 EU financial regulatory environment does not directly address the issue of financial engineering for aggressive tax planning purposes. While there is a general recognition that financial innovation does enable tax avoidance, the EU's position on the taxation of derivatives deployment by companies remains highly varied across the block, with technical expertise driven by the financial sector itself, and with many existing provisions allowing considerable discretion to the companies and member states. This finding is confirmed by our interviews with corporate accountants of EU-based companies and senior partners in law firms servicing capital markets.
- Notwithstanding this oversight, most tax authorities have increased the resources devoted to fighting derivative-facilitated tax avoidance by MNCs, and not one single tax authority has decreased resources.
- Despite the building momentum, what we find is that regulatory reform has been slow to catch up with developments occurring at the intersection between financial engineering and aggressive tax planning. As a result, regulatory authorities have remained somewhat inadequate in responding to concerns expressed by governmental departments and tax experts. A more dynamic regulatory reform therefore, has been wanting. While the politics of vested interests goes some way in explaining the regulatory lag, we find that the lag and resultant blind spots in the EU specifically, may be the outcome of two different philosophies of regulation of financial and real sectors in the US and the EU: the former more granular and independent, the latter more systemic (though blind to 'in-between' spaces) and captured by industry.

The Fintech Sector: An Emerging Issue

Fintech is a technology-anchored universe that is changing very rapidly. The evolution of Fintech has been both fast and diverse, and it is clear that it can develop in any imaginable and as yet, unimaginable directions. Currently, the aspect of Fintech that raises particular concern from the perspective of illicit finance and tax abuse involves crypto currencies, blockchain technology, data mining, peer to peer (P2P) lending, crowdfunding, money transfer services and smart contracts.

Broadly, the rise of fintech is seen as a positive development. Mark Carney, the governor of the Bank of England, recognised fintech's 'huge potential for making the financial system more inclusive, efficient, effective and resilient' (Carney 2017, 12). The EU has commissioned studies of the effect of cryptocurrencies and blockchains on avoidance and evasion. In March 2018 the European Commission adopted an action plan on FinTech to foster a more competitive and innovative European financial sector[1]. The Fed is embracing Fintech too, although with some apprehension.

While technological progress and financial innovation tend to be as forces of economic improvement, Fintech poses an unprecedented set of challenges to governance and public welfare. According to Izabella Kaminska of the *Financial Times*, fintech is nothing but the Eurodollar market 2.0[2]. It combines many elements, from encrypted transactions to hidden identities and e-wallets in cyberspace, each of which is perfectly geared to enable crime and tax evasion. Below we consider some of the potential for tax avoidance produced by the new technology.

The key problem with bitcoin and other copycat crypto currencies, Kaminska argues, lies in the security/access paradox. "If the sector is easily accessible (highly competitive) it's not secure, and if it's secure it's not easily accessible. Put differently, the more entrants there are, the easier it is for criminal enterprises to exploit the sector for their own ends" (Kaminska 2016). And that is exactly what is happening in the cryptocurrency space. An Australian study estimates that about 47% of transactions involving bitcoin are conducted on the dark net. *Litecoin,* second-most popular cryptocurrency (after Bitcoin) preferred by Russians, is now accepted by nearly one third of all dark-web vendors.

The American IRS treat cryptocurrencies not as currency, but as a capital asset, subject to rules governing stock and barter transactions when exchanged for dollars. In other words, the IRS considers these currencies a speculative investment. The users of currencies tend to behave differently. In an investigation of one platform, the IRS showed the court that out of 14,000 customers, only 802 people reported gains or losses from Bitcoin in 2015. Early data from one popular tax preparation service shows that only a minuscule proportion—just 0.04%—of US tax filers have reported cryptocurrency gains or losses to the IRS in the first half of 2018. That's far fewer than the 7% of Americans who are estimated to own Bitcoin or another cryptocurrency, and who are likely to owe taxes to the IRS on those investments.

In addition, Bitcoin could theoretically allow wealthy speculators to complete complicated commercial transactions, such as tax-exempt stock and gold-swapping trades that involve buying agents acting as fronts by using local currencies to facilitate the exchange. And that is exactly what appears to be happening in response to first stage of regulations of cryptocurrencies.

Our study reveals similar problems with initial coin offerings (ICO) and initial token offerings (ITO) as well as Blockchains. This suggests that cryptocurrencies have the potential to become What University of California-Irvine law professor Omri Marian has dubbed 'super tax havens' (2013) (Marian, 2013).

Smart Contracts and the Legal Entity Identifier

Complex finance, combined with Fintech is generating another set of transformations, potentially of paradigmatic scale. The entire system of taxation is focused on taxable events visible through a stable contractual world. Until very recently counterparties would enter, for instance, into a financial swap arrangement recorded either on a platform or 'over-the counter', i.e, as private agreements between two parties. Regulators were traditionally

[1] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/fintech_en

[2] Back in the late 1950s, the Eurodollar market, a market that emerged in London almost by accident, had swiftly plugged a hole in the entire post-war regulatory regime known as the Bretton Woods system.

interested in achieving a great degree of transparency of the recorded contracts for a variety of reasons, to ensure stability and that due tax is paid. The world of smart contracts is introducing a change, however, in the nature of the contract itself. Increasingly, an algorithm pulls together actor's intention and would generate automatically contracts that anticipate those actor's wishes. The algorithm choses counterparties, often without prior knowledge of those counterparties. Furthermore, the algorithm may change counterparties during the life of the transaction. This may result in a situation that whereby contracts are increasingly exposed to scrutiny, counterparties may change over time. Under such circumstances, the entire system of taxation, already under heavy pressure from finance and Fintech, many not be up to scratch.

What is needed is a system of reporting of tax liabilities through proper feed of these fluid contracts, i.e., who did what, when and under what conditions. As it happens, the best candidate to support such system has emerged already as solution to a different problem experienced during the financial crisis. The collapse of Lehman Brothers in 2008, made explicit significant shortcomings relating to the identification of market participants as legal entities. Because of the lack of a unique or uncontested identifier for legal entities engaged in financial markets transactions and an inability to see how legal entities related to one another in terms of the ownership of assets and liabilities, it had been impossible for regulators to have advanced warning of any concentration of liabilities via subsidiaries that a consolidating entity might be accumulating..

The response of financial markets regulators, led by the US market authorities (SEC, CFTC) and channelled initially through the Financial Stability Board (FSB) and then the G20, was to propose the institution of new market-wide and cross-jurisdictional identification standard for the uncontested and unambiguous identification of legal entities engaged in any kind of financial markets transactions across asset classes and trading venues. Through this proposed global identification infrastructure the regulators anticipated that it would be possible to establish a new regulatory regime that could be forward-looking rather than reactive to a market crisis after it has occurred, but also support more effective corrective action to protect market integrity during and after a crisis.

The design of a standard identifier format was developed in conjunction with the International Standards Organisation (ISO) (Financial Stability Board 2012, International Standards Organisation 2012), the mandating through regulations and other legal instruments of the use of the identifier in the reporting of financial markets transactions, the establishment of an issuance and maintenance infrastructure for the data linked to the identifier, and associated governance arrangements (Legal Entity Identifier Regulatory Oversight Committee 2015). All this would collectively form what is now referred to as the Global Legal Entity Identifier System (GLEIS). At the centre of the GLEIS is the Global Legal Entity Foundation (GLEIF), not-for-profit consortium that oversees the operation of the system. GLEIF, among other things is responsible for issuing and validating LEI identifiers to those who apply for them through Local Operating Units (LOUs) around the world. GLEIF's business model for the LEI's IDI is premised on the free use of an ostensibly open infrastructure through a cost-recovery model whereby the promoters of the infrastructure justify their strategic positioning as guardians of accuracy and integrity and charge accordingly, through the costs that are recovered, for their service.

Key questions in this direction that are motivated by the research undertaken as part of WP1 on the development and adoption of the GLEIS identification infrastructure are as follows:

- Can standardised cross-jurisdictional legal entity identification and the corporate structure mapping it facilitates also help in better understanding and the financial markets-based mechanism used by MNCs for tax evasion and tax avoidance?
- What investigative/research methods could be used in order to undertake such mappings and accompanying tracing of cash flows?
- Would the evolving GLEIS identification infrastructure also be suited for these purposes or would it need to be modified/expanded or another identification infrastructure developed?
- How does the GLEIS identification infrastructure compare to existing identification infrastructures used for tax reporting/AEoI (UTI, GIIN), for such purposes?
- Are there gaps/loopholes that legal entity-based identification result in?

It is clear from our interviewing that GLEIF is interested is widening the scope of LEI. GLEIF and SWIFT are already working on a cross-referencing and mapping of LEI and BIC datasets, while the BiS is also considering the inclusion of the reporting of LEIs for all legs of correspondent banking transaction and the OECD allows for the use of the LEI for the automatic exchange of information (AEoI) for tax purposes as an alternative to UTIs. Since GLEIS is a non-profit organisation and its cost recovery model does not generate obvious conflict of interest and its data appear to be the most accurate among the limited number of relevant data sets that are available, we believe that the LEI technology can help redress some of the challenges to taxation introduced by smart contracts. We recommend that the EU consider widening participation of EU corporate entities in the LEI process and support efforts for the cross-referencing and mapping of datasets around a unique cross-jurisdictional identifier such as the LEI.

Conclusions

Just as anticipated, considering that the demand for avoidance is not subsiding, regulatory tightening is in danger of having the squeezed balloon effect: squeeze the balloon on one side, and it inflates on another. There is little doubt that the latest regulatory efforts of the OECD, the US and the EU are having an effect. But just as traditional venues of avoidance are becoming more difficult, an issue that had remained largely under the radar for many years, the use of financial instruments for tax avoidance, is rearing its head. As the traditional banking industry was put on the spot, and compliance powers increased tremendously, an alternative venue is emerging through the Fintech industry which creates the danger of ‘democratizing’ avoidance and evasion. And just as technologies of information identification, certification and exchange are being improved, certain potential ‘gaming’ of the system is evolving through the introduction of smart contract technology. As a result, therefore, that are new clouds visible on the horizon and great care and vigilance will be required in the future.

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