A Toolkit on Illicit Financial Flows:
Module 2

Combating Illicit Financial Flows in the Extractives Sector in Asia

APMDD
ASIAN PEOPLES' MOVEMENT ON DEBT AND DEVELOPMENT

Southern Regions Program https://financialtransparency.org/

About the project:

As a unique space under the Financial Transparency Coalition (FTC), the Southern Regions Programme (SRP) plays a crucial role of an incubator by placing just tax systems and financial transparency at the heart of development debates. In October 2017, during a South-South strategy meeting it was recognised to bring out a collaborative document that emerged from the perspective of the Global South. Five members[1] of the SRP came together to author the IFF Toolkit in an effort to address issues of financial secrecy, enablers of illicit financial flows, lopsided impact on domestic resources and the ability to raise further resources due to loss of revenue as IFFs and the much-needed reforms in the international financial architecture set in the context of Global South. The toolkit uses case study-based evidence to simplify the issue of tax abuse. The document also covers tax incentive abuse as a subject under IFFs. The toolkit has benefitted from discussions held at the Nepal Social Forum (March 8th-10th, 2018), Paper on Illicit Financial Flows: Rights, Restoring Justice and Freedom and Pan-Continental Southern Dialogue on Illicit Financial Flows[2], Nairobi (November 21-22, 2018).

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1 Asian People's Movement on Debt and Development (APMDD), Centre for Budget and Governance Accountability (CBGA), Latin American Network on Economic and Social Justice (LATINDADD), Pan African Lawyers Union (PALU) and Tax Justice Network Africa (TJNA)

2 See more here - https://financialtransparency.org/ftcs-pan-continental-southern-dialogue-illicit-financial-flows-nairobi-21st-22nd/

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Combating Illicit Financial Flows in the Extractives Sector in Asia

List of Acronyms

AAAA	Addis Ababa Action Agenda
AE	Adaro Energy
AI	Adaro Indonesia
APAC	Asia and the Pacific
CCA	Coal Contract of Agreement
DTAA	Double Taxation Avoidance Agreement
EI	Extractive industries
EITI	Extractive Industries Transparency Initiative
FDI	Foreign direct investment
GDP	Gross domestic product
IASB	International Accounting Standards Board
IFFs	Illicit financial flows
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
NRC	Natural Resource Charter
NRGI	Natural Resource Governance Institute
PWYP	Publish What You Pay
TNCs	Transnational corporations
UNCAC	United Nations Convention Against Corruption
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific

Contents

1 Introduction and Background

Extractive industries (EI) involve any process to extract raw material from the earth, most commonly oil, gas, metals and minerals. Oil, gas and mineral resource wealth is widespread in developing countries and often accounts for large shares of countries' gross domestic product (GDP), export earnings, government revenue and jobs. It currently generates about $3.5 trillion in annual gross revenue throughout the world, which translates to roughly 5% of global GDP[1]. However, evidence suggests a 'resource curse' hounding mineral-rich countries who generally perform worse than their counterparts in economic terms[2]. In this module, we look into the some of the reasons behind this.

Perhaps, the most corrosive feature of EI is the fact that high economic rents which characterise this sector create room for illicit financial flows (IFFs)[3]–this includes but is not limited to abusive transfer pricing, trade misinvoicing, tax abuse through corporate tax structures, corruption, misappropriation of state assets, etc. IFFs deprive countries, especially in the Global South, of crucial revenue that they deserve, thus inhibiting their ability to establish sound institutions, law enforcement processes and agencies as well as capacity within public bodies to check the various modalities of IFFs in the extractives sector.

1.1. Why is the extractive sector prone to IFFs?

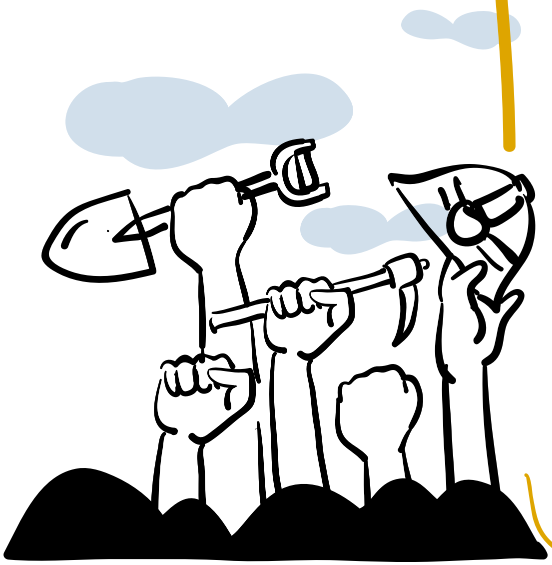
First, there is a high degree of discretionary political control within the sector. Concentration of natural resources in certain geographical areas as well as their economic and revenue potential often leads to the extractives sector being controlled by the office of the head of the state and a few technocrats, with extremely opaque processes governing it[4]. Further, the discretionary funds generated by the sector increases the autonomy of political leaders who control the governance of EI, thus reducing transparency and accountability and increasing resistance to reform.

Second, there is extremely limited competition in the extractives sector, resulting in fewer checks and

Extractives Industries and Human Rights

While extractives industries are vital to the economy of several developing countries, companies in this sector are often accused of being involved in serious human rights abuses, including displacement of communities, environmental pollution and degradation, poisoning of land and water, denial of freedom of expression and association, child labour, and attacks on and killings of human rights defenders. There are different impacts on human rights along different phases of the value chain of extractives.

Perhaps the most systemic way in which EI impact human rights is by contributing to illicit finance across the world. IFFs have severe and differentiated impacts in countries in the Global South, which have inadequate funding for public services such as education, public hospitals, water and sanitation, public infrastructure, social protection and gender equality—all of which play a crucial role in the lives of the citizenry, especially marginalised communities. IFFs disproportionately impact women and their human rights, as they end up being taxed more and bear the brunt of inadequate public services.



balances compared to other more competitive sectors.

Third, the distinction between public, shareholder and private interests in the extractives sector is often blurred. State-owned companies may cater to the interests of their political patrons, while government officials may have vested financial interests in the sector. Public officials may also sit on the Board of Directors of private extractive companies, and thus have financial stakes in the profitability of these businesses.

Fourth, the extractives sector involves technical and financial processes that are complex, niche and require a great level of expertise. This sector is probably one of the very few in the entire world which is self-governed to a large extent, especially in developing countries. Instead of government agencies, companies carry out accounting for tax payments themselves. Thus, if auditing capacity is limited or corrupt, companies may engage in cost inflation, mispricing and manipulation– activities that are particularly harmful within the extractives sector, given the high reliance of countries on revenue from this sector.

High-level intergovernmental processes and initiatives too have drawn attention to opacity entrenched in the extractives sector, linking this with the sector's potential for facilitating IFFs. The outcome document of the Third International Conference on Financing for Development, the Addis Ababa Action Agenda (AAAA) underscores as one of the action areas "the importance of corporate transparency and accountability of all companies, notably in the extractive industries."[5]

The report by the High-level Panel on Illicit Financial Flows from Africa (popularly referred to as the Mbeki Panel) also linked the extractives sector with IFFs, warning that "[c]ountries that are rich in natural resources and countries with inadequate or non-existent institutional architecture are the most at risk of falling victim to illicit financial flows". It further observed that the extractives industry exercises a "high degree of discretionary power and political influence"[6].

2 Extractive Industries Sinking its Teeth into Asia

Exploring the interlinkages between EI and IFFs becomes even more crucial given the sheer size of revenue, scale of operations and reach of Northern-based giant mining transnational corporations (TNCs) into richly mineralised but impoverished developing countries in Asia. APAC's share of mineral and energy production rose from 33% of the global total to 48% between 2000 and 2015.[7]

Underscoring the need for a careful weighing of socio-economic costs and stricter regulation, the extractive sector's contribution to GDP in a number of Asian countries often pales in stark contrast to the large profits gained by mining investors and the irreversible damage to the environment. In India, for instance, mining's contribution to GDP has remained below 5% even after liberalisation, while small and medium enterprises contribute an estimated 29% with more employment generated and less harm to people and natural resources.[8] The Philippines exhibit a similar situation; the sector contributed 0.85% in 2017 to GDP, with a slight rise from 0.79% in 2016.[9]

While taxation of natural resource extraction is a sovereign decision, mineral regimes interact with trade, investment, finance and international tax in a complex manner, leading to gaps and overlaps, and often weakens revenue collection.

2.1 Modalities of and risks involving illicit financial flows from the extractives sector

IFFs generated from the extractives sector can

Table 1: Sources of illicit financial flows generated by the extractives sector

	Corruption	Illegal exploitation	Tax abuse
Financial flows	Bribes paid by companies, money embezzled from tax collection and budgetary allocations	Undeclared corporate revenues from illegal resource exploitation	Inflated costs deducted from taxable revenues, smuggling of resources
Main beneficiaries	Corrupt government officials and companies gaining undue advantage	Domestic companies, local subsidiaries of foreign companies	Parent or holding companies, exporting companies

Source: Based on U-4 Anti-Corruption Resource Centre, 2011

be categorised into three sources, each from operations that reward different beneficiaries; sources that are not mutually exclusive but often go hand-in-hand. The first source consists of corruption, involving abuse of public authorities for personal interest. The second source consists of revenue from illegal resource exploitation in which the state does not receive its legal share. The third source is tax abuse by the companies in the extractives sector.

Further, the risk of illicit financial flows varies greatly across the different phases of mining activities. A study by the UN Economic Commission for Africa applying the extractive industry's value-chain analysis to mining projects in several African countries illustrates this (see Table 2).

Table 2: Modalities and risks involving illicit financial flows along the extractives value chain

Licensing

Illegal Exploitation

Risk Level: Low
Key method: Bribery; commissions
Loopholes: Non-compliance mechanisms; weak law & order enabling trespassing beyond the gazetted areas

Tax Abuse

Risk Level: High
Key method: Bribery; commissions; nepotism
Loopholes: Weak fiscal regimes; weak capacity of tax administrations, including human resource challenges

International Third Party Effects

Risk Level: High
Key method: Bribery; commissions
Loopholes: Unfair bidding & award processes due to interference from third parties

Exploration

Illegal Exploitation

Risk Level: Low
Key method: Bribery; commissions
Loopholes: Non-compliance mechanisms; weak law & order enabling trespassing beyond gazetted areas

Tax Abuse

Risk Level: High
Key method: Fraud
Loopholes: Weak oversight institutions and weak accountability mechanisms

International Third Party Effects

Risk Level: Low
Key method: Unlawful gifts & commissions
Loopholes: Unfair bidding & award processes extortion

Development

Illegal Exploitation

Risk Level: High
Key method: Bribery; unlawful gifts and commissions
Loopholes: Non-compliance with contractual arrangements

Tax Abuse

Risk Level: High
Key method: Bribery; kick-backs; commissions; fraud
Loopholes: Lack of enforcement of mineral sector regulations (e.g. procurement irregularities)

International Third Party Effects

Risk Level: High

Key method: Bribery; kick-backs; commissions; fraud
Loopholes: Lack of enforcement of mineral sector regulations (e.g. procurement irregularities; over-invoicing of materials)

Production

Illegal Exploitation

Risk Level: High
Key method: Bribery; commissions; fraud
Loopholes: Weak accountability mechanisms which enable underreporting and undervaluing of the minerals

Tax Abuse

Risk Level: High
Key method: Bribery; kick-backs; commissions; fraud
Loopholes: Lack of enforcement of mineral sector regulations allowing for transfer mispricing; over-invoicing

International Third Party Effects

Risk Level: High
Key method: Bribery; commissions; fraud
Loopholes: Weak accountability mechanisms, which enable underreporting & undervaluing of the minerals

Transport, storage and marketing

Illegal Exploitation

Risk Level: High
Key method: Bribery; commissions; fraud; racketeering; extortion; smuggling
Loopholes: weak accountability & enforcement mechanisms, including customs

Tax Abuse

Risk Level: High
Key method: Bribery; racketeering; commissions
Loopholes: Lack of enforcement of mineral sector regulations allowing for transfer mispricing; under-invoicing

International Third Party Effects

Risk Level: High
Key method: Bribery; racketeering; commissions; smuggling
Loopholes: Lack of enforcement of mineral sector regulations allowing for transfer mispricing; under-invoicing

Processing and marketing

Illegal Exploitation

Risk Level: High
Key method: Bribery; commissions; fraud; racketeering; extortion; smuggling
Loopholes: Weak accountability & enforcement mechanisms

Tax Abuse

Risk Level: High
Key method: Bribery; kick-backs; commissions; fraud
Loopholes: Lack of enforcement of mineral sector regulations allowing for transfer mispricing; misinvoicing

International Third Party Effects

Risk Level: Medium
Key method: Bribery; racketeering; smuggling
Loopholes: Lack of enforcement of mineral sector regulations allowing for transfer mispricing; under-invoicing

Abandonment and decommissioning

Illegal Exploitation

Risk level: Low, except for post decommissioning on illegal exploitation
Key method: Bribery; commissions; fraud; racketeering; extortion; smuggling
Loopholes: weak enforcement mechanisms

Tax Abuse

Risk Level: High, through early exit or fabricated bankruptcy
Key method: Bribery; kick-backs; commissions; fraud
Loopholes: Lack of enforcement of mineral sector regulations

International Third Party Effects

Risk Level: High, through concealed off-shore transfers of shares amongst foreign MNCs
Key method: Fraud, fabricated bankruptcy, bribery
Loopholes: Lack of enforcement of mineral sector regulations relating to profit repatriation.

Effects on budgetary allocation on mineral rich countries

Illegal Exploitation

High impact
Key method: Money-laundering; smuggling
Loopholes: Political instability; weak noncompliance mechanisms

Tax Abuse

Very High impact
Key method: Bribery; kick-backs; commissions; fraud
Loopholes: Lack of enforcement of mineral sector regulations allowing for under-invoicing of imports

International Third Party Effects

Very High impact
Key method: Embezzlement; kickbacks; fraud; white-collar crime; insider-trader on commodity exchange markets
Loopholes: Weak public financial management systems; weak oversight institutions; inadequate accountability mechanisms

Source: United Nations Economic Commission for Africa (2017)

While providing an overview, a caveat to reading Table 2 is that it significantly collapses the extractive process and does not allow interrogation of the defining factors before, after and in-between these discrete stages. Moreover, it is the extractive industry's own value chain analysis, i.e., proceeding from the concern for commodities and their market value, competitive edge and opportunities for increasing business profits illustrating private sector interests based on profit maximisation. "This perspective… follows the commodity instead of the assets of the government," notes the Natural Resource Governance Institute (NRGI). A more expansive approach proceeds from the responsibility of states to maximise value for their citizens, and the author's attempt to highlight the possible loopholes for tax abuse and IFFs are shown in Table 3.[10] This is an initial effort that invites further development based on different contexts.

Table 3. Value chain approach to natural resource wealth and peoples' wellbeing

Arriving at the decision to extract

Features

- Defining the extraction framework.
- What is value/valuable to people and the environment, and value creation?
- Undertaking a cost-benefit analysis before, during and beyond the project time-frame (requiring access to information on corporate structures, beneficial owners, governance, among others)

Some questions to plug loopholes for tax abuse and IFFs

- How were the licenses obtained and contracts awarded?
- Are there overlapping, conflicting laws and policies?
- Were "politically exposed persons" involved? Were the affected communities adequately

and meaningfully consulted; Was free, prior and informed consent secured?

- How were social and environmental safeguards complied with? Is the identity of the beneficial owners disclosed?

Country examples of issues

IFFs arising from illegal activity:

Indonesia: Due to overlapping regulations and the licensing system, between local governments, ministries of Energy, Forestry and Natural Resources resulting in illegal contract awards (e.g., open pit mining in conservation forests protected from any extractive activity).[11]

Getting a fair deal

Features

Defining a sustainable, climate-responsive and rights-based framework for awarding rights to explore and extract, and establishing the legal and financial terms governing those rights.

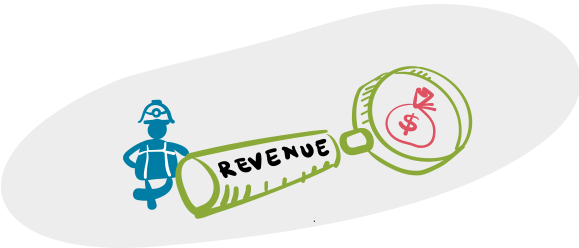
Some questions to plug loopholes for tax abuse and IFFs

- How were the terms negotiated?
- What were the governing rules?
- Are specific terms left to bidding, based on a general law? Or negotiated on an *ad hoc* basis?
- Are there fiscal and non-fiscal incentives offered? How are these rationalised, assessed over time, regulated, and what are the fiscal costs?

Country examples of issues

Disadvantageous mining tenurial arrangements (favoring corporations):

Philippines: Under the Financial and Technical Assistance Agreement (FTAA), the State only gets the share provided for by law only after the contractor has fully recovered its pre-operating, exploration and development expenditures, whenever that may be since there are no time prescription. Furthermore, this share is defined as consisting of taxes, fees and duties. Additional share (on top of taxes, etc.) from profits may never be reached because of unrealistic conditions. These include the proviso in the implementing rules that the investor will only give an additional "share" only if net, after-tax income exceeds 40% of gross output for two consecutive years. Data covering nine years before 2011 showed that the highest net income after tax/ gross output ratio was only 25%, with the average ratio at 16% over a nine-year period.[12]



Ensuring transparency in revenue payments

Features

Ensuring the collection of all kinds of payments, as spelled out in the extraction contract and the legal framework.

Some questions to plug loopholes for tax abuse and IFFs

- What cross-border transactions are involved?
- Are fees payments and revenues regularly published?
- Are revenues forgone from tax incentives weighed against actual payments?
- Is information publicly accessible (including language), unconditionally available and comprehensive? Are these subjected to independent, credible and participatory audits, and reconciled by equally credible, independent administrators? Is civil society actively engaged?

Country examples of issues

Inadequacy, inaccessibility of information:

Cambodia: Bidding procedures have not been publicly announced, nor has the actual bidding process been announced. There is even less information on the resource revenues. Information available from the budget is not disaggregated into the different fees and taxes in the extractives sector. Other sector fees such as from licensing are also lumped under domestic licensing.

A 2011 mapping of information availability in connection with oil and gas deposits found on Cambodian territory found no publicly available data on draft laws and regulations (new petroleum law, taxation of oil operation, taxation of mines; expected areas of exploration/ extraction; bidding procedure for oil and mining; licensing fees for oil and gas operations).[13]

Managing resource revenues

Features

Fiscal management: disposition of revenues;

addressing the issue of fluid commodity markets and the risk of dependency; safeguarding against corruption

Some questions to plug loopholes for tax abuse and IFFs

- Are revenues equitably and sustainably distributed and used?
- Are affected people and communities prioritised?
- Are mechanisms adequate for transparency and accountability and against corruption, and are sanctions clearly defined?
- What are the safeguards against commodity swings? Is public spending decoupled from resource revenues (i.e., with funding from stable revenue sources)?

Country examples of issues

IFFs arising from contexts where states are captured by elite interests:

"Myanmar's jade licensing system is wide open to corruption and cronyism. The main concessions are in government-controlled areas of Hpakant Township, Kachin State, and blocks are awarded through a centrally-controlled process which multiple industry sources say favours companies connected to powerful figures and high-ranking officials"[14].

Investing for sustainable development

Features

Requiring systematic, sustained and periodic monitoring and evaluation; transparent and participatory audits of public expenditures.

Some questions to plug loopholes for tax abuse and IFFs

- Is revenue use in line with the human rights obligations and sustainable development agenda?
- How are the needs and interests of excluded, marginalised and vulnerable groups prioritised?

Country examples of issuess

Myanmar:
Global Witness estimated the value of jade production at $31 billion in 2014 alone, a figure that is 46 times bigger than government's public health spending.[15]

*Note: This table is heavily informed by NRGI's publication on "The Value Chain".[16]

3 Indicators of Abuse in Extractive Industries

3.1 Tax abuse

There are various, though not exhaustive, indicators for detection of tax abuse by companies in the extractives sector.[17] Such indicators can be used as early warning signs or detection tools for law enforcement agencies to strengthen the fight against such tax abuse. Most of these indicators must be considered in a specific context and in relation with other indicators. They often vary on a case-by-case basis. These indicators should raise concerns over the possible avenues for tax avoidance and motivate further investigation.

a **International offshore corporate structures** that abuse national and international tax laws, especially those that have offshore entities within corporate structures located in low tax or secrecy jurisdictions[18] are a useful starting point. Offshore companies incorporated in tax havens are frequently used or abused for tax avoidance and as a tool to commit various financial crimes. Further, a shareholder of a company can also be located in a tax haven. Trust or corporate service providers–along with offshore law firms, banks and accountancy firms–provide services such as acting directors or granting domicile, thus masking the true owners[19] of the company.

b **Manipulating and misreporting volume or value of commodities and trade flows** involve under- or over-valuing the prices of exported minerals to shift profits within the corporate structure of the mining company, known as abusive transfer pricing. Oil, gas and mineral reserves can also be under-valued at the exploration phase, or production values or the quality of extracted resources could be misreported to avoid various different types of taxes, including corporate tax and capital gains tax.

c **Financial statements, payments and financial flows** form important indicators regarding the prevalence of abusive tax practices by mining companies. Intellectual property rights such as patents and trademarks are often placed in related entities incorporated in low tax jurisdictions, enabling local mining companies to transfer considerable volumes of royalties to such entities and engagement in profit shifting. Intra-group loans between different entities belonging to the same corporate structure may be used to shift costs from high tax to low tax jurisdictions. Thin capitalisation[20] may also be applied, implying that the local mining company is financed with relatively more debt and less equity than is common in business practices. Further, dividend payments from the local mining companies to the parent company could be redirected via entities registered in secrecy jurisdictions instead of following hierarchical lines, resulting in tax abuse. Local mining companies could also under-report profits by accelerating depreciation of its assets–taxing deduction for the cost of the asset can reduce taxable income. Lastly, the absence of reporting operations, profits and payable taxes by companies on a country-by-country basis can also be considered an indicator for tax abuse.

d While the tax base being lowered through various methods discussed above is a sound indicator, **tax payments can also be abused**. Companies could increase their reported income to shareholders, legitimately or illegitimately, while reporting lower profits to the country's tax revenue authorities, indicating tax abuse. Bilateral tax treaties between a country where mining operations are carried out and the country where the parent entity is registered could also aid in lowering the tax burden. In some cases, an intermediate holding company can be incorporated in a third country with whom the parent company's host country has a bilateral tax treaty. Though such arrangements are often cited for reasons of 'tax planning' or 'tax efficiency' by parent mining companies in their annual reports, these arrangements are ultimately abusive of national tax structures. Mining groups can further seek an advance tax ruling from the revenue authority of the country where resource extraction is going to take place, most often due to power imbalances and asymmetric information.

3.2 Trade misinvoicing

Trade misinvoicing is a method for moving money illicitly across borders which involves the deliberate falsification of the value, volume, and/or type of commodity in an international commercial transaction of goods and services by at least one party to the transaction. By fraudulently manipulating the price, quantity, or quality of a good or service on an invoice submitted to customs, criminals can easily and quickly shift substantial sums of money across international borders.[21]

In the extractives sector it is one of the largest drivers behind large volumes of IFFs, arising from massive illegal mining and the export of mining commodities which go largely unrecorded. In Indonesia's case, for instance, IFFs swelled considerably between 2003 and 2014 in the oil, gas, mineral and coal sectors at twice the national growth rate. In only a decade, IFFs rose from IDR 11.80 trillion in 2003 to IDR 23.89 trillion in 2014. This accounted for about $2 billion or over 10% of total IFFs from Indonesia in 2014.[22] Large discrepancies have also been found between the data reported in South Africa's custom data and the data reported by its trading partners–between 2000 and 2010, South Africa's data shows $2.8 billion and $2.3 billion of exports under the head 'non-monetary gold' in two different datasets, while its trading partners report $59.7 billion of non-monetary gold exported from South Africa. During the same period, under-invoicing of iron ore exports from South Africa to China was worth $3 billion.[23]

While all data discrepancies are not necessarily IFFs, unrecorded trade transactions are prevalent and provide channels for moving illicit finance across borders, warranting a close watch to assess for fraudulent trade behaviour and tax abuse.

3.3 Transfer pricing abuse

Transfer pricing is the rule or method of pricing transactions between two companies that are part of the same transnational company group. For example, when a Nepalese subsidiary transacts with a Vietnamese subsidiary belonging to the same parent entity, the price of that transaction is known as the transfer price. However, for the transfer price to be legitimate, it should be comparable to the price of a transaction between unrelated entities (known as market price) which is informed by the 'arm's length principle'.

Transfer pricing is one of the most fundamental building blocks of the current international accounting and tax system. While transfer pricing is not, in itself, illegal or necessarily abusive, two related companies trading with one another may artificially distort the price at which trade is recorded for minimising their tax bill. Transfer pricing manipulation or abuse is common and rampant and is one of the primary drivers of IFFs.

EIs have a long and complex value chain, involving

Case study: Dirty money flows from dirty coal

The Jakarta-based firm Adaro Energy (AE) has swiftly grown into one of the largest producers of thermal coal in Indonesia and South-East Asia. By 2017, it declared a net profit of more than $480 million, surpassing Indonesia's largest coal producer. In 2018, AE's revenues leaped up to $3.6 billion. AE's also has a large offshore presence in well-known tax havens and secrecy jurisdictions: Coaltrade Services International Pvt. Ltd. in Singapore, Arindo Holdings Ltd. and Vindoor Investments Ltd. in Mauritius, and more recently, Adaro Capital in Labuan, Malaysia.

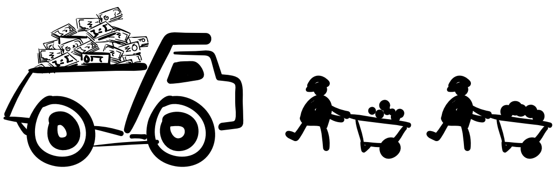
PT Adaro Indonesia (AI), AE's biggest mining company, operates Indonesia's single largest coalmine under a 30-year Coal Contract of Agreement (CCA). Awarded in 1982, the CCA targeted investors for Indonesia's still fledgling coal industry, with an incentive that protected early investors against any changes in Indonesian tax and investment laws. The CCA program underwent changes in later years to favour fully owned domestic players, but the first CCA holders such as Adaro maintained a greater advantage.

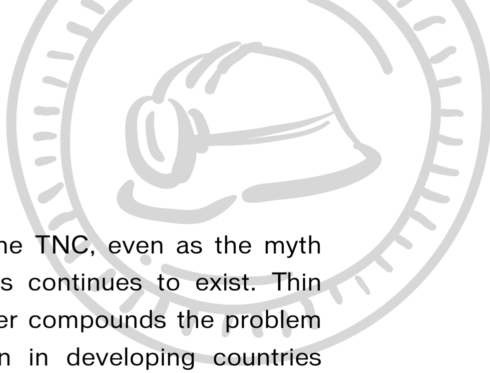
At one point, the Indonesian Finance Ministry brought about new rules that disallowed coal producers to offset input VAT from output VAT; and removed the VAT exemption on materials and equipment. When questioned for offsetting claims for recoverable VAT against royalty payments, AI cited CCA terms that, "the Government will pay, assume and hold AI harmless from all Indonesian taxes, duties, rentals and royalties levied by the Government imposed after the date of the CCA." The Supreme Court eventually ruled in 2017 that while AI had to settle the unpaid royalties, it will be refunded for VAT payments made after coal production became VAT-exempt in 2000.

Further, warning signs of profit-shifting through tax avoidance schemes is clearly illustrated by AIs' dealings with its Singapore-based holding firm, Coaltrade Services International Pvt. Ltd. Indonesian revenue officials found out that Coaltrade had bought coal from AI at $32/tonne and subsequently sold it to third parties when prices rose to $39/tonne. Profits were then booked in Singapore and taxed at only 10.7% (as compared to Indonesia's 50.8%). The company later agreed to settle the dispute by paying $33.2 million to the government.

For almost a decade, Coaltrade sourced more than 70% of the coal it was selling, from Adaro subsidiaries in Indonesia. Global Witness estimated that between 2009 and 2017, Indonesia had forgone corporate taxes of $125 million or $14 million/year. Meanwhile, Coaltrade enjoyed a spike in commissions from an annual average of $4 million to almost $55 million during the period.

Adaro Indonesia holds a "Golden Taxpayer Status" award, the latest of many accolades for being a model taxpayer. Have the profit-shifting to tax havens and the massive revenues forgone been lost in the tax-privileged world of the Indonesian coal sector?





numerous possible transactions between affiliated companies, which can be broadly grouped into two categories: (i) the sale of minerals and/or minerals rights to related parties; and (ii) the purchase of various goods, services and assets from related parties–transactions common to most companies in the extractives sector.[24]

Mining TNCs rely on the complex webs of related subsidiary entities, some of which are incorporated in low-tax or secrecy jurisdictions. Transactions between these subsidiaries can be at a discount or at inflated prices to 'transfer' profits from high-tax to low-tax jurisdictions. Adaro Group's transactions, discussed in the previous case study, illustrate transfer pricing abuse in the extractives sector, and reveal how setting the practice of price setting of intra-group transactions as part of a tax planning policy rather than arm's length pricing.

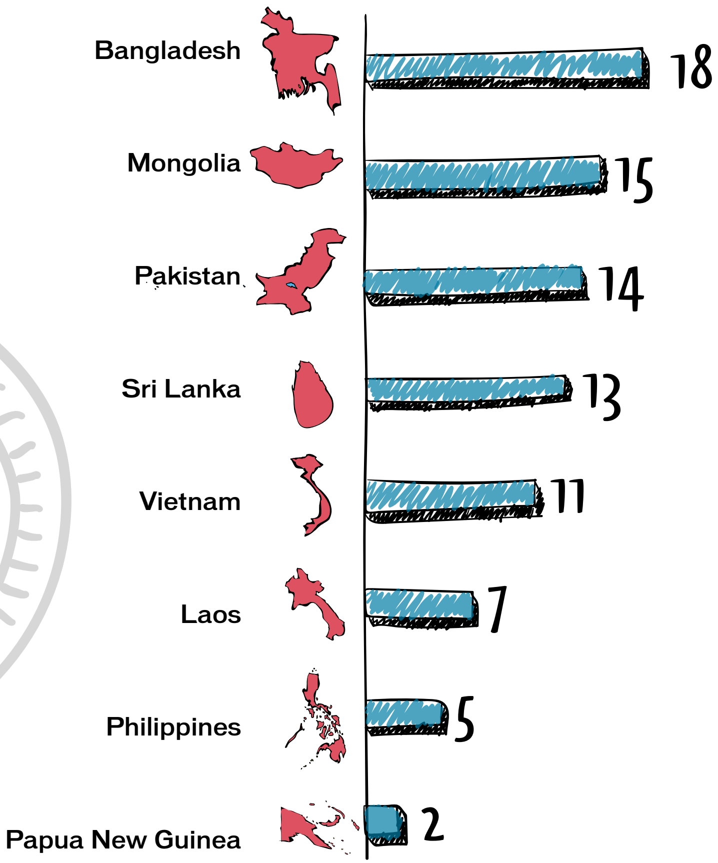
Transfer pricing abuse also manifests in the ways that corporations raise financing, especially when this is done through intra-group lending. Also referred to as debt shifting, a TNC in a high-tax jurisdiction or its residence country typically borrows at high-interest rates from affiliates in low-tax jurisdictions or where interest income is tax exempt. The borrower then reports large interest payments as part of deductible business expenses while the lender pays little or no tax. This plainly redounds to the benefit of the TNC, even as the myth of separate entities continues to exist. Thin capitalisation further compounds the problem of revenue erosion in developing countries hosting extractive activities. Asian countries such as Cambodia, India, Indonesia, Lao PDR, Myanmar, the Philippines and Thailand do not have rules that guard against excessive debt and interest deductions; or subject the debt to equity ratio to certain conditions such as those provided by tax incentives and tax treaties.

3.4 Tax treaty shopping

The international tax system dates back to the early 20th century, when most businesses and corporations were national, international economic flows primarily consisted of trade and portfolio investment, and multinational corporations (MNCs) were in their infancy. The tax system was therefore shaped by domestic tax laws from that period and Double Taxation Avoidance Agreements (given business motivation to avoid being taxed twice). Informally called bilateral tax treaties, DTAAs now number 3,000-4,000 across the world.

Most countries sign DTAAs or bilateral tax treaties with the ambition of attracting investment, but evidence remains inconclusive on this.

Figure 1: Low-income Asian countries with the highest number of restrictive treaties



Source: ActionAid (2016)

A majority of DTAAs are signed between a developed and a developing country, and are restrictive on the rights of the source country[26]

to tax global corporations as they (i) place restrictions on the tax rate of income earned in the source country, including a cap on withholding taxes for dividends, interest payments, royalties and fees for management, and technical and paid to residents of the contracting states; (ii) set limitations on what can be taxed (e.g., definition of what constitutes a permanent establishment[27]), which would otherwise trigger tax obligations under domestic law; and (iii) exempt other types of income (e.g., capital gains) earned in the source country from incurring taxes in that jurisdiction.[28]

A pertinent example in this case would be Mongolia's tax treaty with the Netherlands. The Oyu Tolgoi mine, an open pit and underground mining project in the southern part of the Gobi region has one of the largest gold and copper deposits in the world and is currently operated by the global mining group, Rio Tinto. In 2009, Rio Tinto's Canadian subsidiary Ivanhoe Mines (now Turquoise Hill Resources) transferred a large part of its shares in the copper mine project to a Dutch entity. This resulted in freeing Rio Tinto's Mongolian subsidiary from either the 10% withholding tax in the original investment agreement or the 5%

withholding tax under the Mongolia-Canada tax treaty, and totally exempting it under the Mongolia-Netherlands treaty.[29]

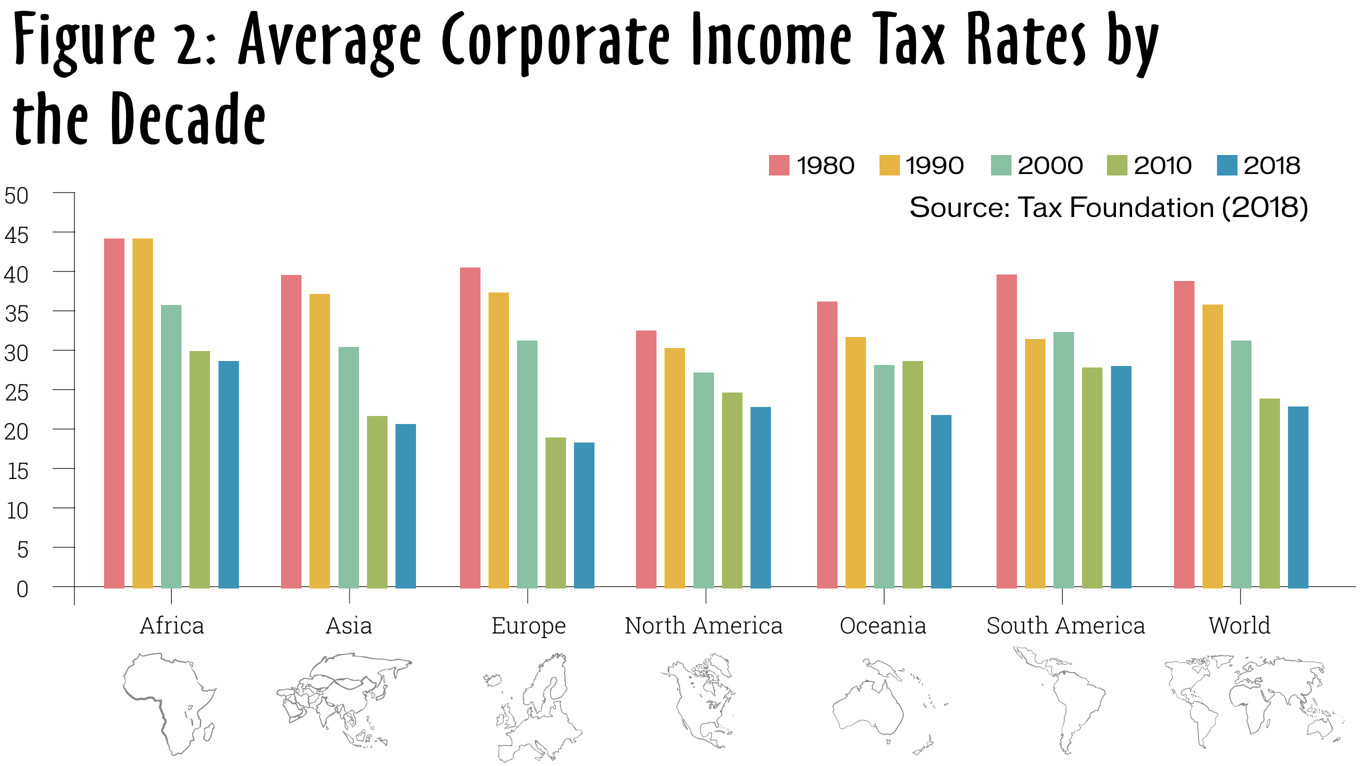
The Mongolian government informed the Netherlands in 2011 that it wanted changes in their tax treaty, but the latter refused. Later that year, the Netherlands conceded only one amendment – allowing a 5% tax on dividends. This was far below the 20% withholding tax Mongolia usually levied on dividends paid out by mining firms. Mongolia cancelled the tax treaty with the Netherlands in September 2012. Unfortunately, Mongolia had already agreed to 'stabilising' or freezing the terms of the original agreement. As a result, withholding taxes were lowered from 20%, then 10% and finally 6.6%, resulting in a reduction of Rio Tinto's tax obligations by $232 million.[30]

Unlike Mongolia's decision of cancelling its tax treaty with the Netherlands, India renegotiated its tax treaty with Mauritius for nearly a decade. Signed in the early 1980s, the treaty provided for Mauritius-registered firms acquiring shares in India-based firms to pay capital gains tax on the sale of these shares only in Mauritius. However, Mauritius did not levy capital gains tax. In effect therefore, the tax treaty, meant to prevent being doubly taxed on the same economic activity, resulted in double non-taxation. The renegotiated 2016 Protocol made the important change of allowing India as the source jurisdiction to levy taxes on the transfer of securities to Mauritius-domiciled entities starting April 2017.[31]

Tax treaty shopping (or treaty shopping) leads to substantial tax abuse by TNCs, aided by differences in withholding tax rates of thousands of bilateral tax treaties throughout the world. MNCs match tax treaties from which tax treaty benefits can be claimed by coursing FDI or dividend payments through countries with the lowest withholding tax rate. Studies have also established links between low withholding tax rates and the diversion of foreign investments by MNCs through third-party countries; a direct route between treaty partners would otherwise have been less profitable.

3.5 Liberalised investments and incentives regimes

A substantial number of Asian countries' increasingly aggressive corporate tax incentives regimes have given way to intense tax competition between these states, resulting in a 'race to the bottom' to attract the most investment by offering lowest possible tax rates to investors and businesses. Despite states recognising the impact on revenue tax incentives have, they continue to offer them.[32]



This proliferation of tax incentives regimes provides a virtual roadmap for shifting profits to the lowest tax jurisdictions. The corporate tax base of a country can be eroded significantly by income shifting schemes employed by TNCs. Besides the production location, TNCs have an opportunity to choose the location of profit too, and exploit and gaps and loopholes in national and international tax law to shift profits to low tax jurisdictions. Facing different statutory tax rates in the jurisdictions where they have operations, they have an incentive to use transfer pricing to concentrate expenses in the country with the higher tax rate and income in the country with the lower tax rate. This type of income shifting typically occurs after they take full advantage of tax allowances available in a jurisdiction where they have an operation.[33]

Eligibility requirements, calculations, rates, instruments, etc. vary at national and sub-national levels across countries but both profit-based and cost or productivity-based incentives are commonly offered across Asian countries. Lowering corporate Income tax rates has also grown into an established trend (see Figure 2).

Corporate income taxes remain a significant source of revenues for developing countries. Since the value of income tax holidays is proportionate to the reported profits earned, they benefit the biggest corporations that, in the first place, need the least amount of state support. These include mining TNCs that do not need tax incentives as they are established, highly profitable enterprises, but end up receiving incentives plainly because of the resource-seeking and location-specific nature of their business.

The role of government, regulatory reform and transparency initiatives

Several initiatives have been developed to improve transparency, accountability and governance of the extractives sector. Many of them have come into existence through the push of developed countries and international financial institutions and without benefit of public perusal and consultation, especially with extractives-affected communities.

4 Engaging Initiatives for Transparency and Accountability in the Extractives sector

In the growing pressure to curb illicit financial flows, transparency and accountability have become widely recognised by states, multilateral bodies and international institutions as requisites for building and defending public financial resources. The extractives industry in particular has come under closer scrutiny over the last two decades on transparency and accountability. It involves large capital investments by global transnational firms in resource-rich developing countries where large segments of the population also remain persistently impoverished. Many of these countries also lack infrastructure for adequate public provision of basic social services, thus raising governance questions over mining investments.

Examples of initiatives and mechanisms engaged by civil society to bring transparency standards to bear on the extractives sector are listed in this section. The EITI, for one, has helped provide information on corporate revenue payments to the public at large, and normatively, bound questions of transparency with the extractives sector. The need remains though, for critical study of strategies and programmes, greater efforts in consulting civil society, especially affected communities and excluded marginalised groups, and undertaking informed, participatory processes to ensure the effectiveness and responsiveness of initiatives.

Extractive Industries Transparency Initiative

Brief Description

This multistakeholder association of corporations, states and civil society is organised under Norwegian law and defines itself as “the global standard for the good governance of oil, gas and mineral resources”. It advocates the open and accountable management of these extractives sub-sectors “based on the principle that a country’s natural resources belong to its citizens”.[34]

Entry points for CSOs

The EITI standard is implemented through multistakeholder groups (MSGs) at the national level, formed at the lead of government after it commits to sign up to the process. Composed of the mining sector, government and civil society, the MSGs work out reporting guidelines, seek disclosure of payments and revenues, examine discrepancies, and ensure that information is disseminated.

The EITI agreed in 2016 on including in the standard, the requirement to disclose the ultimate beneficial owners should by January 1, 2020. Progress is being monitored and evaluated on whether extractive firms are providing information on the name, nationality and country of residence of the beneficial owner, and also identifying involvement by "politically exposed persons".

Possible Drawbacks

Organisationally, as a voluntary initiative, it does not cover all extractive firms. These covered are not required to disclose their payments openly, but only to country members of EITI. This is problematic for regions like Latin America with only two members (Peru and Argentina), and Asia with four members (Philippines, Mongolia, Myanmar and Timor-Leste).

The US withdrew from the EITI in 2017 citing legal impediments. But this has been challenged by civil society; corporations' resistance to disclose revenue payments is alleged as the main impediment to EITI implementation.[35]

Other concerns point to the lack of tighter requirements to compel states to disclose how revenues from the extractives sector will be spent.

The focus on transparency while important is not sufficient to hold states and corporations accountable, and weed out corruption. Transparency mechanisms will only work where there is public awareness, committed and organised actions and an independent media.

Natural Resource Governance Institute (NRGI)

Brief Description

NRGI was set up in 2013 from the joining of two initiatives, the National Resource Charter and the Resource Watch Institute. Its goal is to "to help countries manage their natural resources for the public good by leveraging our expertise working with civil society, parliaments, governments, the private sector, media and other partners".

Approaches include research and data analysis, developing policy advice and capacity development. It also has country presence in select countries where it looks at country needs and demand and relates this to aspects of the natural resource decision chain.

Entry points for CSOs

NRGI works in partnership with citizens, governments, and other actors in these areas: development of mechanisms for transparency and oversight; strengthening fiscal systems and contracts; reforming state-owned enterprises; and management of resource revenues.

Resource governance encompasses "the rules, disclosures, oversight procedures and enabling environment that allow citizens to hold their government to account for managing their extractive resource wealth".[36] (Natural Resource Governance Institute, p. 1).

To assess these, the NRGI has developed the Natural Resource Governance Index, reported as the only comprehensive international index dedicated to measuring the quality of governance in the oil, gas and mining sectors of 81 countries. These include Bangladesh, Cambodia, India, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Timor Leste and Vietnam.

Possible Drawbacks

On indexes in general, summary data is important to guide policy makers, and inform civil society advocacy efforts. But there are also debates concerning the sources and quality of date (reliability and adequacy), lack of transparency and consultation, comparability, the absence of gender indicators, etc. The launch of the African Peer Review Mechanism–a governance tool–is one example of moves towards developing more in-country and/or region-led initiatives.

Civil Society led Initiative

Publish What You Pay (PWYP)

Brief Description

PWYP is both a campaign for transparent, accountable extractive industry, and a global movement seeking to ensure that revenues from oil, gas and mining drive development. From its beginnings in 2002, it reports a 700 member-network that includes human rights, development, environmental and faith-based groups.

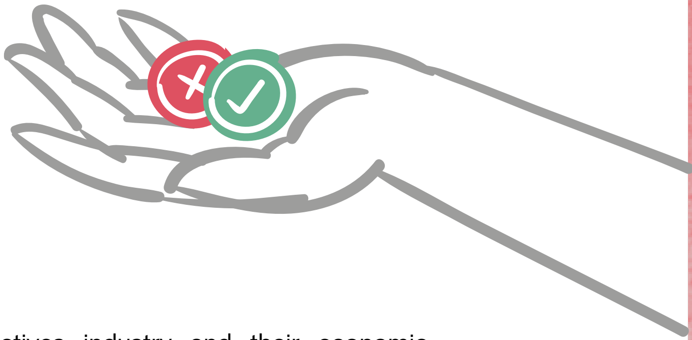
Entry points for CSOs

The PWYP Strategy for 2020-2025 rallies to a vision of a "people-centred agenda for the extractive sector", which entails "pushing for governments to regulate natural resource extraction in an open and accountable way, for companies to operate within an effective governance framework, and for a civil society with the skills and freedom to drive natural resource extraction that benefits all".[37]

Strategic goals include promoting knowledge across its membership, building knowledge through research, advocacy and linking with other movements (e.g., climate, gender and tax justice movements).

Data Extractors Program–an ongoing global initiative that trains participants in uncovering extractives data, specifically to "expose discrepancies in company and government reports and payments to reveal corrupt practices with the ultimate goal of reversing the resource curse".[38]

5 Recommendations



Illicit flows from EI are massive and are closely connected with governance and developmental issues. One of the immediate challenges is to connect the dots between agendas and movements, such as those around the sustainable management of natural resources; the equitable use of resource wealth, human rights, gender equality, and tax and fiscal justice In the face of significant challenges, participatory and multi-pronged approaches are critical to synergise the efforts of policy-makers, civil society organizations, social movements and multilateral platforms to curb and eventually put an end IFFs.

For civil society, steps towards curbing opportunities for IFFs in extractives should include --

- Conducting an independent citizens' review of the preferential tax treatment in the extractives industry and their economic, social, environmental and fiscal justice impacts.

- Developing the principles for the comprehensive reform of the fiscal regimes governing the extractive industry.

- Raising capacity on understanding and monitoring the mechanisms and strategies for IFFs especially tax avoidance schemes utilized by extractives firms.

For policy-makers, it is important to develop a keen sense where and how IFFs may occur in the extractives industry. It is thus urged that more concerted efforts be made towards –

Enhancing transparency and accountability

Transparency and accountability should be extended along all phases of extractives activities, within and across national borders, from pre-bidding conditions, licensing and awarding of contracts, and actual exploration and production processes, to mine closures, rehabilitation and payment of compensatory damages. Risks of IFFs can be identified and independently assessed if laws, implementing regulations, contracts and other vital information are made publicly available. Beneficial ownership, asset ownership and other registers should be publicly accessible for scrutiny in all jurisdictions.

- There is a need to make transparency disclosures mandatory. Greater transparency in markets, especially on resource prices, also has the potential for reducing IFFs as well as reducing price volatility. Country-by-country reporting with lower public thresholds needs to be made mandatory for companies involved at the various stages of the extractives value chain.

- Physical audits of illicit material flows should be made mandatory to assess if volumes of production and export are reliably measured and officially reported.

- Customs agencies should treat trade transactions involving tax havens or secrecy jurisdictions with the highest level of scrutiny and request additional due diligence.

Addressing corruption and tax abuse

- While countries are now obligated to enforce stricter standards against corrupt practices due to the United Nations Convention Against Corruption (UNCAC), they are less concerned about their extraterritorial responsibilities especially with regard to the activities of their companies overseas. States, as members of international human rights organisations have obligations relating to acts and omissions, within or beyond its territory, that have effects on the enjoyment of human rights outside of that State's territory

- Business groups in the extractives sector which have subsidiaries registered in or routing profits through low-tax and secrecy jurisdictions present significant challenges to tax authorities. This requires multilateral engagement and cooperation on tax matters in a platform where developing countries are on an equal footing.

Weeding out opportunities for corporate tax abuse and IFFs in the extractives sector is part of bigger and long-standing struggles and movements for tax and fiscal justice. Supporting these cross-cutting demands thus works to advance efforts to curb IFFs in the extractives industry:

- Global inequalities in taxing rights provide favorable environments for MNCs to engage in profit-shifting schemes, at the expense of countries in great need of public revenue. An intergovernmental body under the auspices of the UN and a legally binding UN Tax Convention offer ways forward. For both measures to be realised, critical mass and political will are key elements.

- Allocate financial and technical resources to strengthen capacity of tax administrations especially in developing countries hosting large mining investments.

- Put in place or enforce mechanisms for the public disclosure of the beneficial, or actual, owners of companies.

- Require public country-by-country reporting from multinational corporations operating and/or registered in their jurisdictions to report on their global commercial activities, structures and tax payments.

- Support the call for the automatic exchange of tax information, with the objective of shining a light on illicit finance, their channels and enablers, including tax havens and freeing up these resources that could go into SDG implementation and the enjoyment of human rights. Developing countries require time and finance to capacitate their tax administrations; and until such time, it is only fair that reciprocity is not imposed as a condition in information exchange.

End Notes

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18 Tax havens and secrecy jurisdictions are countries or even regions within countries that provide an escape from tax, tightly lidded financial secrecy and a complete avoidance of criminal laws and regulations.

19 Beneficial owners are true human owners, who either directly or indirectly profit from and/or control or have voting rights in a company.

20 Thin capitalisation refers to the ratio of debt to equity.

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26 Source country is one where economic activity actually takes place, profit is made and value is created. Source countries are typically developing countries.

27 The provision on "Permanent Establishment" (PE) in tax treaties,

spells out the various conditions by which a foreign corporation/ taxpayer becomes subject to tax obligations in the source country. Tax consulting firms thus typically advice their clients against triggering PE status. Tax treaty templates such as those of the UN and the OECD show important differences in the definition of PE under the UN model, there are more conditions whereby PE can be more quickly claimed, thus benefitting the investment-receiving country in terms of the tax revenues it can collect.

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How to Use the Toolkit?

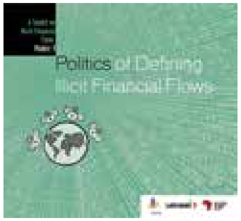
The toolkit is as an easy and accessible resource for enthusiasts, activists, civil society organisations, practitioners and journalists. Designed in a modular format, the toolkit aims to enable evidence based advocacy from the perspective of developing countries[1] for bringing awareness, policy change, exchanging examples of effective interventions from the Global South and wider collaboration between different actors. Please note that the policy recommendations are aimed to be adapted and tailored across settings, regions and priorities.

All modules are designed independently from each other but are structured in a holistic manner. It is recommended that Module 1 be read first as it sets the premise for this undertaking. The toolkit fulfils three objectives -

- Provides a well-rounded perspective of illicit financial flows from the Global South context and delving into its regional components.
- Introduces terms that are set under the framework of human rights, gender justice and the sustainable development agenda with respect to redressing the impact of illicit financial flows.
- Uses a multi-pronged approach to involve the larger civil society, practitioners and journalists through international and regional mechanisms, simplified case studies to demystify complex topics and examples of successful interventions across the Global South.

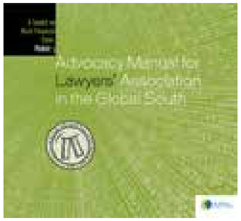
The toolkit is available in print and online. The technical module is also available in Spanish.

A Toolkit on Illicit Financial Flows



Module 1: Politics of Defining Illicit Financial Flows

Module 2: Combating Illicit Financial Flows in the Extractives Sector in Asia



Module 3: Advocacy Manual for Lawyers' Associations in the Global South

Module 4: Addressing Illicit Financial Flows – National, Regional and Global Interventions

Module 5: Technical module: The Role of Banking in Latin America as a Facilitator of Illicit Financial Flows

1 The toolkit uses the terms developing countries or regions interchangeably with the Global South. The term 'Global South' represents countries in the developing regions of Africa, Asian and Latin America, Central America, Mexico, South America, and the Middle east (with the exception of Israel) that share a colonial and imperial past (with the exception of Japan, Hong Kong, Macau, Singapore, South Korea and Taiwan). Southern countries refer to countries belonging to the Global South.

About the Financial Transparency Coalition:

The Financial Transparency Coalition (FTC) is a global civil society network working to curtail illicit financial flows through the promotion of a transparent, accountable and sustainable financial system that works for everyone.

FINANCIAL TRANSPARENCY COALITION

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