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НАУЧНО-ИССЛЕДОВАТЕЛЬСКИЙ ФИНАНСОВЫЙ ИНСТИТУТ

FROM OFFSHORE WEALTH TO OFFSHORE ROBOTS: WILL THE “FINANCIAL CENTERS” PROSPER IN THE DIGITAL AGE?

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Approach towards addressing the question

Research questions:

- **How is the digitalization of the global economy changing the tools and outcomes of the international tax competition?**
- **How will the role of OFC/IFCs in global FDI flows and business structuring change in the age of tax transparency and business automation?**

Research structure

1. How is the digitalization changing the global business & economic environment?
2. How does the digitalization reshape the international tax rules?
3. What are the OFC/IFCs positions in this discussion?
4. What tax instruments & tax policy approaches OFC/IFCs can potentially use for attracting the key value drivers of the digitalized businesses?
5. Is there currently international competition for key value drivers of digitalized businesses between the OFC/IFCs economies at the regional/global level?
6. What is the possible impact of such international tax competition on the FDI flows and digitalised business structures?

Digitalization of the global economy

Key features (OECD BEPS Action 1 Report, 2015)

- High level of **mobility** of key factors of value creation
- Increased role of user's **data** & participation in value creation (network effects)
- **Virtual** & economic scale without physical mass
- Increased role of two-sided business models (**platforms**) & tendency towards concentration of market power
- **Volatility** due to fast technological developments and changes in business model

Examples

New models
- E-commerce
- Cloud computing services
- Participative networked platforms (B2B, B2C, C2C)
- E-payment services
- Algorithmic trading

Traditional businesses
- Block chain in banking compliance
- Robots in manufacturing
- Internet of things in electricity supply
- 3D printing in customizing health products

Digitalization and FDI

- MNEs in highly digitalized industries have a “lighter” FDI footprint than traditional MNEs. They tend to concentrate their operations in a few highly developed countries and their investment patterns are shaped by fiscal and financial motives more than those of traditional MNEs. As digital technologies and business models tend to disseminate across the broader economy, this may suggest the onset of a new era of international production and MNE internationalization paths (Casella, Formenti for UNCTAD 2018)

- Digitalisation is associated with the reliance on financial engineering and SPEs in low-tax countries (about one third of FDIs). However, financial centers still have high inward FDI-to-GDP ratios, even when SPEs are removed. Some entities located in financial centers also take an active management role and are not just passive holding companies (Elkjaer, Damgaard for OECD 2018)

- A shift away from large-scale manufacturing projects toward smaller manufacturing facilities closer to key markets. ICT sector is now the largest sector for FDI measured by number of projects, and third measured by number of job (Institute of Business Value, 2018)

Increased mobility of the key value added drivers

Qualified staff	Algorithms & automatic business processes	Intellectual property (IP) & other intangibles

Relevant business strategies:

- IT-specialists are "international workforce" easily migrating to other countries

- Key digital business processes are not linked directly with the equipment (server, robots, etc.) situated in the given jurisdiction

- Legal rights related to IP/intangibles can be easily transferred

<u>Instability (fluctuation) of the parts of the global value creation chain</u>

Remote economic activity

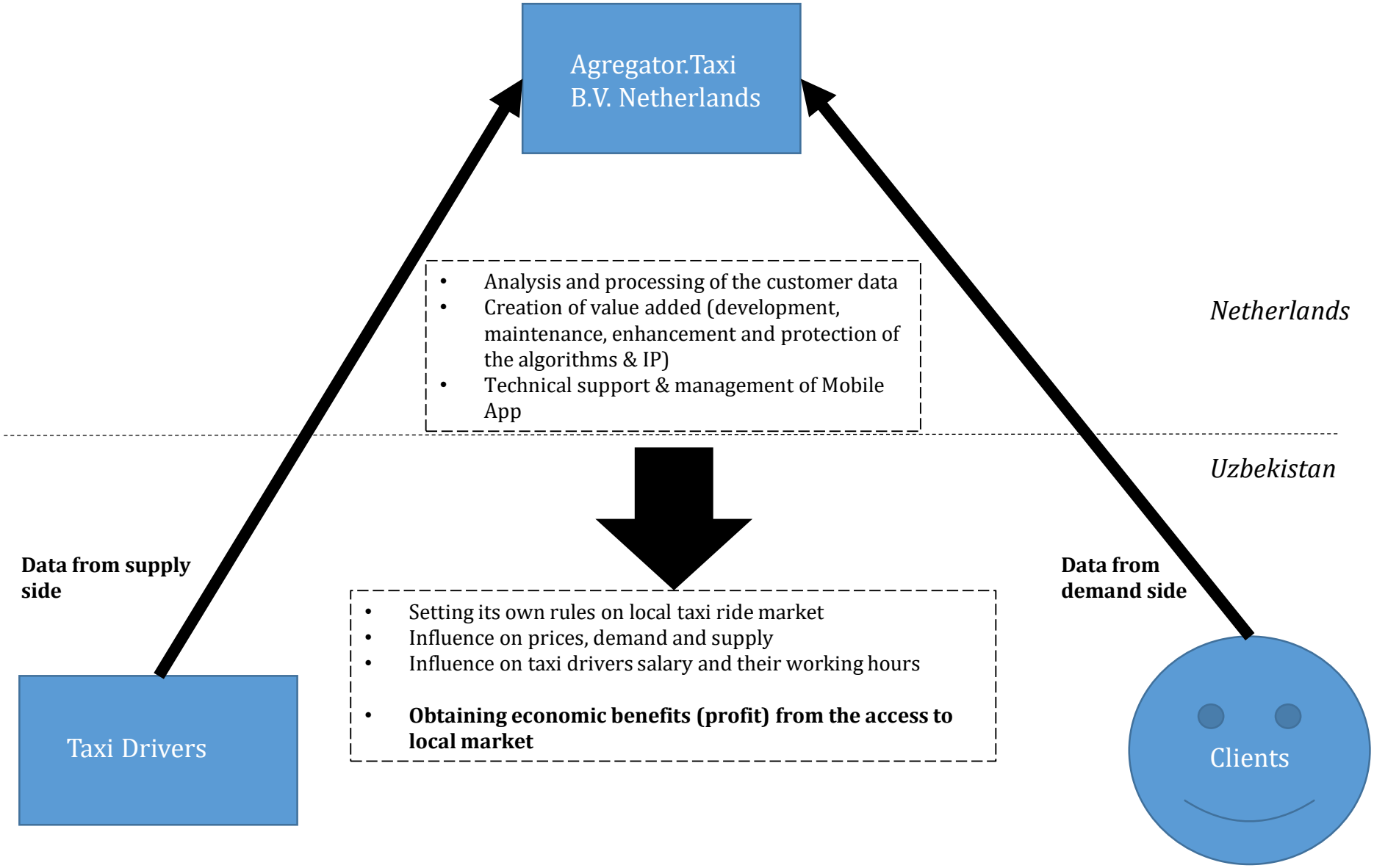
Qualified staff	Algorithms & automatic business processes	Intellectual property (IP) & other intangibles

Relevant business strategies:

• IT-specialists can work remotely for projects all around the world under flexible conditions (freelance/service contract)	• Offshore-located equipment (server, robots, software, artificial intelligence, etc.) can be important value driver under the new business models	• IP and other intangibles can be exploited internationally

Growing and challenging inconsistency between the places of economic presence (real and less mobile) and the places of value creation (virtual and highly mobile)

Taxi Aggregator Business Model



What do we mean by OFC/IFC?

"OFC is a center where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents" (IMF, 2000)

Characteristics of OFC/IFCs

- "Booking" of transactions in jurisdictional legal framework without relevant economic substance taking place in the jurisdiction
- Legal and service infrastructure for investment-related and business services (fund management, inheritance, M&A deals, SPVs, insurance, trust business, tax planning, IBC activity)
- Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies

  and
- More popularly, centers which provide some or all of the following services:

- low or zero taxation;
- moderate or light financial regulation;
- banking secrecy and anonymity

- The level of "added value" and "non-resident bias" in the services provided differs greatly between different OFC/IFCs

Digitalisation – a second chance for the OFC/IFCs?

Opportunities

- OFC/IFCs economies inherently relate more on international than on national economic activities. MNCs from the OFC/IFCs generate most of its revenue from other states and have most of its assets abroad (UNCTAD, 2018)
- OFC/IFCs generally have little own physical resources in terms of population, land, natural resources (UNCTAD, 2018)
- OFC/IFCs economies have best and most stable legal systems (Baker McKenzie, 2017)
- OFC/IFCs economies business and legal environment is familiar to global businesses (Baker McKenzie, 2017)

Challenges

- The best workforce still works in large economies, where they can benefit from the education and scientific infrastructure, population size, digital ecosystems (OECD, 2018)
- The most of revenue is also generated in large economies, where the main markets are located (OECD, 2018)

Digital transformation of tax systems – main consideration for OFC/IFCs

Indirect taxes

- VAT rules shall be absolutely neutral and harmonized with the trade partners both in terms of goods and services trade *(OECD, International VAT/GST Guidelines, 2017)*

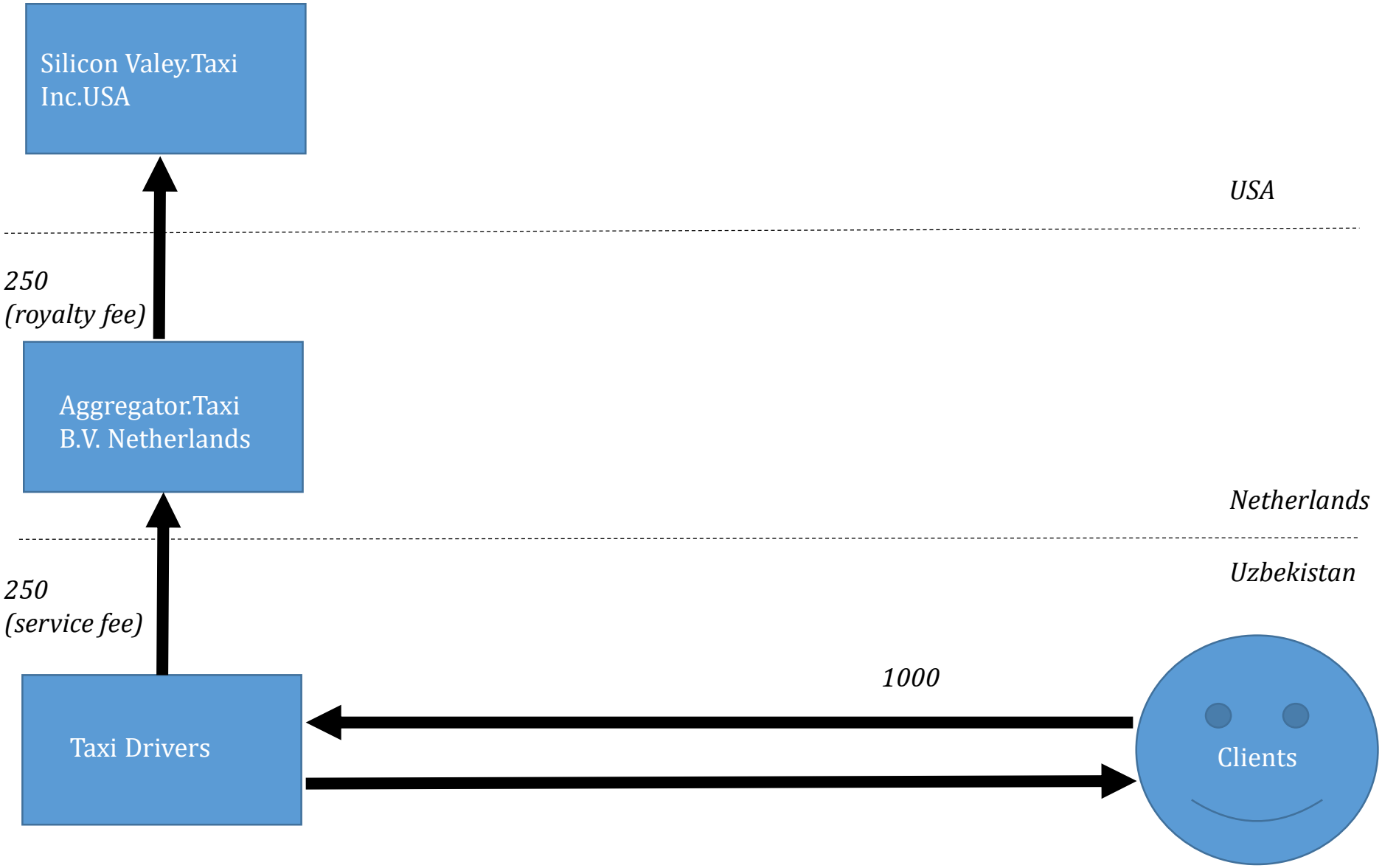
- Special emphasis shall be made on the rules relating to deduction of input VAT in order to ensure that if one of the intermediate value creation stages is made into the "OFC/IFCs" it does not create any irrecoverable VAT costs and cascading effects (Kollmann, 2019 (IBFD))

- Digital invoicing and risk-control approach fits best for tax administration *(OECD, Tax Administration, 2017)*

- VAT treatment of digital supplies shall be methodologically clarified in details and shall not create any breach of neutrality in the international context *(Kollmann, 2019 (IBFD))*

- Minimum compliance burden for VAT on import B2C digital supplies (Liu, Ooi, 2019)

Taxi Aggregator Business Model



Digital transformation of tax systems – main consideration for OFC/IFCs

Corporate income tax

- Tax incentives for the mobile value drivers: staff, IP and equipment (Ghosh et al., 2019, Arginelli, 2015 and others)
- Tax incentives for investing in the digital assets and fintech (ICO, etc.) (Bal, 2018)
- Allocation of sufficient taxing rights under the international tax framework to the "value creating" jurisdictions vs. "market jurisdictions" (OECD, 2019 and other)
- Detailed transfer pricing methodology and documentation in order to support the relevant profit allocation to the "value creating" jurisdiction in cross-border disputes (OECD BEPS Actions 8-10 Report)
- International cooperation in advance pricing agreements and rulings in order to ensure tax certainty (OECD, Tax Certainty 2018)
- Global transparency and information exchange (FATF (2018))
- Territoriality of scope of income taxation (Xu, 2018)
- Low withholding taxes on payments for IP (Cotrut et al., 2015)
- Corporate residence criteria based on virtual value creating presence in the jurisdiction (author's idea)

Digital transformation of tax systems – main consideration for OFC/IFCs

Personal income tax

- Tax incentives for the relocation of key value creating staff and their family members (Beretta, 2018)
- Tax incentives for start-up founders (IFA Cahier, 2015)
- No exit taxes for staff leaving the jurisdiction (Beretta, 2018)
- Tax residence rules modernized in order to reflect mobility of individuals (such as simplified tax residence rules for newly arrived expats) (author's)
- Tax incentives for remote employment through telecommunication networks (author's)
- Digitalization of tax compliance and administration (Alink, van Kommer, 2016)

Digital transformation of tax systems – main consideration for OFC/IFCs

Robotax considerations

- Marginal tax costs for one robot vs. marginal tax costs for one human – ensuring neutrality in the digital unemployment prospective as tax competitiveness pre-condition in the digital age (Berberov, 2018)

(Tax wedge is defined as the ratio between the amount of taxes paid by an average single worker … and the corresponding total labour cost for the employer. The average tax wedge measures the extent to which tax on labour income discourages employment (OECD, Tax wedge, 2018))

- Tax incentives for robots' creation/relocation (author's idea based on IFA Cahier, 2015)

- Ensuring robot's contributions to the value creation is treated internationally consistently (author's idea based on OECD Discussion under BEPS Action 1):

- for the transfer pricing prospective
- for the VAT deduction and place of supply rules
- for the different "economic substance" anti-avoidance tests

Plan of empirical research

1. Detailed legal analysis of the current international tax policy approaches related to the challenges of the digitalization in the chosen OFC/IFCs and their role for international tax planning

2. Detailed analysis of value creation process in the digitalized business models (cloud computing, fintech, robotics, e-commerce, artificial intelligence)

3. Delineating and quantifying the level of the attractiveness of 5 analyzed OFC/IFCs' tax regimes in the context of specific business models (cloud computing, fintech, robotics, e-commerce, artificial intelligence)

4. Assessing how successful are current OFC/IFCs' tax regimes in attracting the global digitalized businesses by different types

5. Discussing the future impact of the digitalised businesses on OFC/IFCs' tax regimes' transformation and global FDI flows

Many thanks for Your attention!

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