Big Tobacco, Big Avoidance

An analysis of the main tax avoidance structures used by British American Tobacco, Imperial Brands, Japan Tobacco International and Philip Morris International, based on annual reports of parent companies and major subsidiaries in 2010-2019

4 November 2020

THE INVESTIGATIVE DESK

A cooperative of highly specialized investigative journalists

Authors:
Stefan Vermeulen (TheID)
Manon Dillen (TheID)

Co-author:
Dr. J Robert Branston,
Senior Lecturer (Associate Professor) in Business Economics
School of Management, University of Bath, UK

Researchers:
Sergio Nieto Solis (TheID)
Nadia el Khannoussi (TheID)

Editor-in-chief and supervisor:
Dr. Marcel Metze (TheID)

Summary of key findings

There is growing pressure worldwide for companies to pay their fair share of tax. One sector that has lucrative revenue and profits is the tobacco industry (see chart). Although the sector makes billions in revenue, it pays relatively little in corporate taxes.

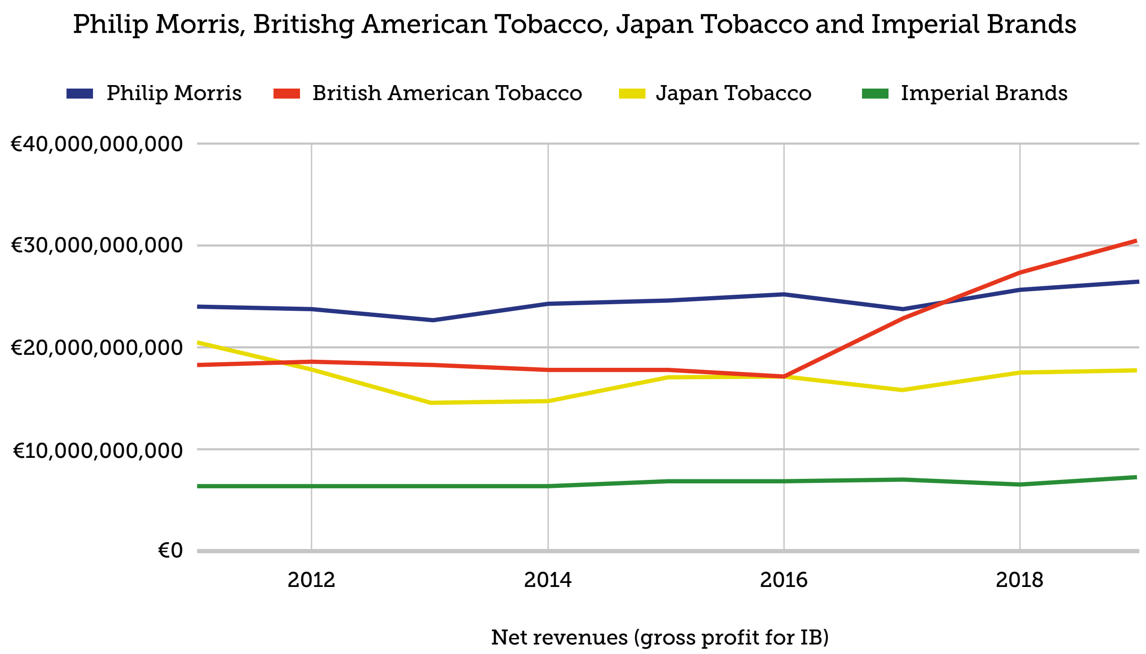
Tobacco's Big Four transnational companies - British American Tobacco, Imperial Brands, Japan Tobacco and Philip Morris - make extensive use of the entire range of common tax avoidance methods.

We did not find any clear evidence of illegal practices (tax evasion), but analysis of their annual reports and those of a number of crucial subsidiaries in the period 2010-2019 shows that all four have 'aggressive tax planning' strategies, in spite of their own codes of conduct suggesting otherwise.

This report details the tax avoidance methods the four companies are using and describes some of the fiscal disputes they are involved in.

It is a first report. Because of the complicated and untransparent nature of tax avoidance it cannot be comprehensive. Many questions remain, particularly concerning the final destination of the money flows involved. The logical endgame is that many ultimately end up in tax havens. In further research we will try to shed more light on this final step in the avoidance chain.

Over €80 billion in revenues



Six European countries play a key role

Six European countries play a key role in the elaborate tax avoidance strategies of Tobacco's Big Four: Belgium, Ireland, Luxemburg, the Netherlands, the UK and Switzerland. Of these, the Netherlands and the United Kingdom clearly have a key role in facilitating conduit subsidiaries. The role of Switzerland might be similarly important, especially in the case of Philip Morris, but is hard to confirm because of its financial secrecy.

€7.5 billion of tobacco profits (annually) pass through the Netherlands

On average, Tobacco's Big Four shift around €7.5 billion of worldwide profits through the Netherlands annually. British American Tobacco and Imperial Brands move these profits on to holding companies in the UK, Philip Morris International to a holding company in Switzerland. Japan Tobacco International seems to send them via the Netherlands straight to the parent company in Japan.

British American Tobacco and Imperial Brands UK subsidiaries lowered their corporation tax burden by £2.5 billion (past decade)

Using the fiscal instrument of group relief, the UK subsidiaries of Imperial Brands and British American Tobacco – both based and headquartered in the UK – lowered their UK corporate tax burden by £2.5 billion between 2010 and 2019. As a result, BAT paid close to zero corporation tax. IB's annual reports are so untransparent that their actual UK tax burden is virtually impossible to determine.

The 2015 BEPS guidelines (OECD) didn't result in higher tax payments but in less transparency

The introduction of the BEPS did affect Tobacco's Big Four, though maybe not in the way intended by the OECD. The companies didn't start paying more corporate taxes or stop engaging in aggressive tax planning. Instead, their financial reporting seems to have become less transparent.

Tobacco's Big Four use five main avoidance methods

Shifting dividends

The €7.5 billion Tobacco's Big Four shift through the Netherlands annually, mainly consist of dividends from subsidiaries.

BAT shifts around €1 billion in dividends via Belgium each year. Tax paid on these profits is less than 1 percent.

Group relief, partly based on internal loans

The two British tobacco giants in particular use group relief (loss compensation) as a major method to reduce their corporate taxes.

Imperial Brands lowered their UK corporate tax bill by an estimated £1.8 billion over the last ten years. BAT lowered theirs by an estimated £760 million.

At both IB and BAT, the losses involved regularly stem from interest paid on internal loans, resulting in eligibility for group relief. There are clear indications that at least part of these loans don't serve any other purpose than lowering their corporate tax bill.

As a result, BAT paid close to zero corporate tax in the UK.

Notional (fictitious) interest deduction

BAT parked around €3.5 billion in assets in three holding companies in Belgium, which from 2010-2017 helped it deduct several millions in notional (fictitious) interest each year. The notional interest deduction diminished over the years and ended in 2018.

Profit shifting via intra-firm transactions

We found several examples of profit shifting via intra-firm transactions. One is the sale – on paper - of all BAT cigarettes produced by BAT Korea Manufacturing Ltd. (South Korea) to Rothmans Far East BV in the Netherlands. They are immediately re-sold to another South-Korean company, BAT Korea Ltd, at a much higher price. This way, on average each year €98 million in Korean profits are shifted to the Netherlands.

Royalty payments

There are clear indicators that PMI and JTI use royalty payments (through the Netherlands) as a tax planning tool:

- Philip Morris Holland BV annually pays between €25 and 29 million in royalties to a foreign entity. For the Dutch BV these are costs, so the taxable profit is lowered considerably.

- Between 2010 and 2013, Japan Tobacco International Group Holding BV shifted about €250 million annually through the Netherlands as royalties. After 2013 they stopped reporting the royalty payments. It is however likely that this subsidiary continued to function as a conduit for royalty payments.

Tax disputes and investigations

Tobacco's Big Four are involved in tax disputes in at least eleven countries over the last ten years, leading to claims by tax authorities ranging from €45 million to €1.2 billion. So far, in the majority of cases, the courts' decisions have been in favour of the companies.

- Philip Morris has been / is under examination by foreign tax authorities in Germany, Indonesia, Russia, South-Korea, Thailand, Switzerland and Turkey .

- BAT has been / is involved in disputes in the Netherlands (a record claim of €1.2 billion), Brazil, South-Korea and Egypt.

- Imperial Brands is involved in three large tax ongoing tax-related legal procedures in France, Russia and the EU, involving tax claims totalling £672 million.

- For Japan Tobacco International, we found three specifications of tax disputes, in Turkey, Russia and the UK.

- In September 2019, the European Commission announced an in-depth investigation into tax avoidance by multinationals. BAT is one of the 39 companies under investigation.[1]

[1] Press release European Commission, 20 September 2019, retrieved from https://ec.europa.eu/commission/presscorner/detail/en/ip_19_5578, 21 October 2020.

Introduction

In recent years, corporate taxation has become a hot topic of debate. Multinational companies have many opportunities to reduce their corporate tax burden through international tax planning schemes. It is generally acknowledged that the social distinction between – in itself legal - tax avoidance and illegal tax evasion is not clear-cut. There is a large grey area in which companies may operate in line with the letter of the law, but against its spirit.

To indicate the abuse of 'technicalities of a tax system or mismatches between two or more tax systems', the European Union uses the term 'aggressive tax planning' (European Commission, 2017). In the public debate this type of tax planning is generally deemed to be socially undesirable.

State-owned China National Tobacco accounts for about 40 percent of global cigarette consumption. The other 60 percent of the international tobacco market is dominated by four transnational groups: British American Tobacco, Imperial Brands, Japan Tobacco International and Philip Morris International (Statista, 2020). In this research we analyse the tax planning strategies of these four in 2010-2019.

The tobacco industry remains one of the most profitable in the world. In their annual reports, Tobacco's Big Four all emphasize their commitment to help the world move towards a future without smoking. Still, all four continue to record billions of euros in profits each year, which are mainly generated by the sales of traditional tobacco products. As yet, their income from new vaping and heated tobacco products is still a fraction of their revenue from cigarette sales.

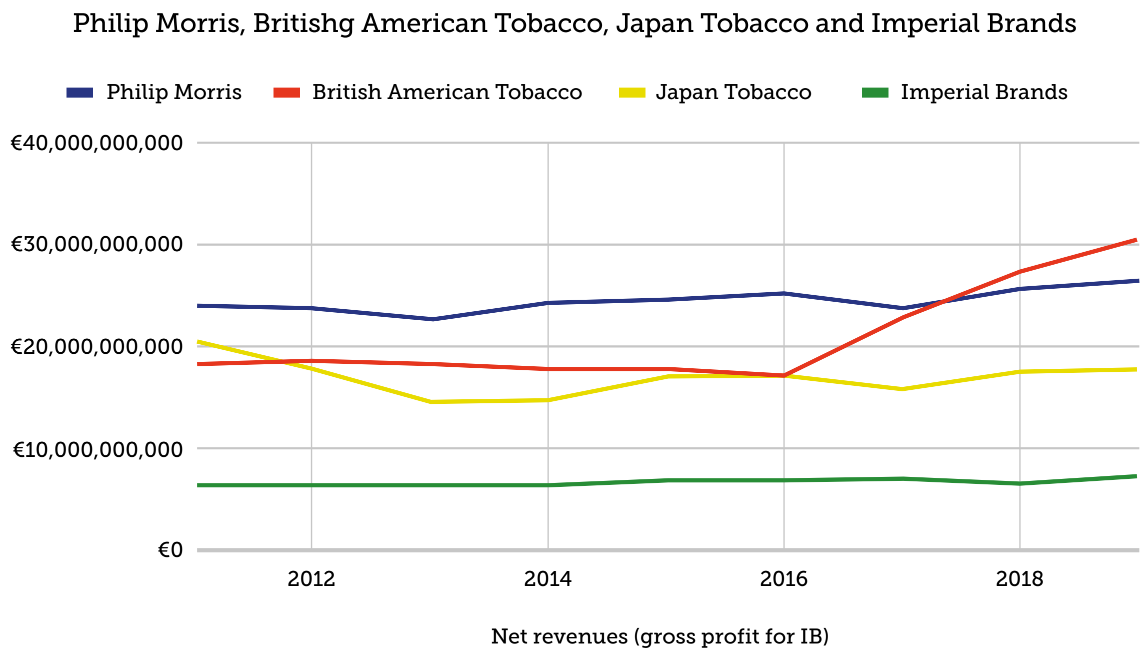


Figure 1: total net revenue in euros as reported in the consolidated annual reports of the parent companies (currencies converted to € at ECB rate year's end, not corrected for inflation, gross profit for IB)

All four companies publish codes of conduct regarding their tax policy. JTI promises 'not [to] undertake transactions whose sole purpose is to create an abusive tax result' (JTI, 2020). BAT reports it must be alert to 'payments or shipments by, through or to companies or individuals established, resident or operating in countries which have the reputation of being 'tax havens' or to bank accounts held in such countries' (BAT, 2020). IB says not to 'engage in deliberate illegal tax evasion or facilitate such evasion on behalf of others' (IB, 2020). And finally, PMI explicitly states: 'We do not engage in artificial tax arrangements or in transactions lacking substance.' (PMI, 2019).

The consolidated annual accounts of these groups make it seem that they do indeed pay a fair share of corporate taxes. However, upon closer look, a different story arises.

The Investigative Desk delved into the financial accounts of Tobacco's Big Four and into those of a large number of their subsidiaries in five European countries that are known to facilitate corporate tax avoidance on an international level, in order to find out which tax planning tools they are using and how they employ these tools. Based on data from these financial accounts we constructed a database with main indicators of tax avoidance and possible tax evasion in 2010-2019.

The present analysis is based on this database and some additional research.

We need to stress that, due to the complicated and untransparent nature of tax avoidance and tax evasion, many questions remain and need further investigation – which we have already set in motion.

We also need to stress that this analysis does not provide any clear examples of illegal tax evasion practices, although we did find some indications that these might be found in further research.

Nevertheless, the analysis shows that Tobacco's Big Four employ all the main tricks in the avoidance handbook, and do that on a large scale.

The analysis is structured as follows:

- In section 1 we show the most common tax avoidance methods of Tobacco's Big Four. Each of these methods is illustrated with the example of a subsidiary company of a tobacco multinational that employs this scheme;

- Section 2 describes the main routes (countries) the companies use for their tax avoidance schemes. This section may also serve as a justification for the selection of analysed countries.

- Section 3 zooms in on each company. It presents the hierarchical structure of its subsidiaries, its associated dividend and interest flows and the tax disputes they are involved in (as can be identified from their annual reports).

- In section 4 we look at the effect of the OECD's BEPS (base erosion and profit shifting) guidelines, which were introduced in 2015, with the intention to stop corporations from avoiding taxes.

- In section 5 we will conclude this analysis with an overview of our most important findings.

- A glossary of terms and definitions is included at the end of the document.

1. Avoidance methods

Tax avoidance is most commonly understood to arise from Base erosion and Profit shifting (BEPS). Base erosion is the use of tax planning tools and financial measures to lower a company's taxable profits. It can be achieved by reducing profit (on paper), or by increasing reported costs. The latter we often see in high impairments on investments, high interest costs, high royalty payments or high costs of goods sold. Profit shifting involves the shifting of taxable profits from high-tax jurisdictions to low-tax jurisdictions. This is achieved by making payments to subsidiaries in foreign countries. These payments are often in the form of dividends, interest, and royalty payments, which are the main indicators of aggressive tax planning as identified by the European Commission (2017).

The acronym 'BEPS' is used for the counter tax avoidance programme of the OECD. We will elaborate on this in section 4.

In order to develop tax avoidance schemes, companies set up a structure of subsidiary companies. These entities can have different functions within the tax avoidance scheme. The European Commission classifies three types of entities. The first is the target entity: this is where the tax base is reduced, usually the parent company. The second is a lower tax entity. This is where the tax base is increased but taxed at a lower rate. The final type is a conduit entity. These entities (subsidiaries) are used to channel money from one subsidiary to another, usually with the purpose to avoid withholding taxes (see glossary) (European Commission, 2017).

Typically, these entities are located in different countries, as different tax regimes allow for different advantageous aspects of the tax avoidance scheme. I.e. countries with low withholding tax or favourable tax treaties on royalties and interest payments provide an ideal climate for conduit subsidiaries, whereas countries with many options for tax deductions will facilitate the second type of entity.

In section 3 we provide an attempt to visualize the subsidiary structure for each company according to the analysed data.

Apart from channelling different streams of money to beneficial fiscal climates, companies use tax planning tools such as group relief, or transfer pricing adjustments.

Below we provide examples as found in the analysed annual reports of the indicators of the main aggressive tax planning methods as described above.

1.1 Income shifting through interest payments

The fact that interest costs are usually deductible from the tax base stimulates companies to finance their activities through the use of debt (for which the cost is interest). This can be done first by borrowing money from an external party (usually a bank). It can also be done within the group of subsidiaries from the same companies, when it is called an 'internal financing structure'. It allows companies to provide loans to other subsidiaries in the group, which can be used as a way to reallocate corporate income to a lower tax jurisdiction.

The mechanism is as follows: a target entity/subsidiary wants to lower its tax base through interest payments. Another subsidiary (the conduit) in another country that does not levy withholding tax on interest grants a loan to the target entity. The target entity pays interest to the conduit. The conduit then channels the interest income to a country with low or no corporate tax.

Indicators of this tax planning tool are a high debt level at the target entity, high interest payments, and low financial profitability. Indicators at the conduit subsidiary are: both high financial income and expenses, high financial assets (loans granted), and high financial liabilities (loans incurred).

We found this structure at, among many others, Rothmans Far East BV, which is a Dutch subsidiary company of British American Tobacco. The subsidiary provided a loan to PT Bentoel Internasional Ivestama TbK, an Indonesian subsidiary. For this it paid in total €963 million between 2014 and 2016. Consequently, the Indonesian subsidiary no longer booked a profit in Indonesia. The Dutch subsidiary subsequently channelled the interest to Jersey through another loan, where interest income is not taxed. The Dutch subsidiary thus merely functioned as a conduit, in order to avoid withholding taxes. Below you can find the annual reports from 2014-2016 of Rothmans Far East BV with the indicators of income shifting through interest payments.

ROTHMANS FAR EAST B.V.

Balance sheet as at 31 December

Before appropriation of profit		2014		2013	
All amounts in EUR'000	Notes				
Fixed assets					
Financial fixed assets	2	359,331		202,083	
Total fixed assets			359,331		202,083
Current assets					
Inventories	3	31,412		1,098	
Receivables	4	92,284		92,608	
Cash and banks	5	480		225	
Total current assets		124,176		93,931	
Current liabilities	6	103,742		89,432	
Current assets less current liabilities			20,434		4,499

ROTHMANS FAR EAST B.V.

Profit & loss account for the year ended 31 December

All amounts in EUR'000	Notes	2015	2015	2014	2014
Net sales	12		213,061		240,688*
Cost of sales	13		(110,025)		(125,688)
Gross margin			103,036		115,000
Selling and distribution expenses	14		(15,588)		(22,197)*
General and administrative expenses	15		(112,509)		(85,181)*
Net result on net sales			(25,061)		7,622
Financial income	16	87,197		46,035*	
Financial expense	16	(77,119)		(34,048)*	
Net financial result			10,078		11,987
Result before taxation			(14,983)		19,609
Taxation	17		2,123		(3,108)*

ROTHMANS FAR EAST B.V.

Notes to the Balance Sheet and Profit & Loss account

All amounts in EUR'000

NOTE 3 ~ LONG-TERM LOANS continued

The fair values and book values of the long-term loans are as follows:

	31 December 2015		31 December 2014	
	Book value	Fair value	Book value	Fair value
Long-term loans to affiliated companies	801,359	737,548	353,653	353,653

The loan to PT Bentoel Internasional Investama TbK (an affiliated group company) commenced on 12 August 2013 with a termination date of on 28 August 2016, for the total amount of IDR 5.3 trillion. Interest terms were based on average 6 month IDR JIBOR and 2.7% margin. On 24 February 2015 the termination date was extended to 30 June 2018. The amount outstanding per 31 December 2015 is IDR 5.3 trillion (2014: IDR 5.3 trillion).

On 24 February 2015 the Company approved a second loan agreement to PT Bentoel Internasional Investama TbK, which commenced on 24 February 2015 and with termination date of 30 June 2018, for a total amount of IDR 6.7 trillion.

Interest terms were based on average 6 month IDR JIBOR and 3.75% margin. The amount outstanding per 31 December 2015 is IDR 6.7 trillion. The aggregate loan amount outstanding per 31 December 2015 is IDR 12 trillion.

On 23 December 2015 the estimated termination date of the loans changed from 30 June 2018 to 30 June 2016 and the loans became interest free effective 1 January 2016. This event classified as substantial modification. As a consequence the loan was derecognized per 31 December 2015 and accounted for as new loan on 31 December 2015. The resulting fair value loss of EUR 63,811 has been recognized in shareholder's equity.

On 27 May 2016, the Company approved the early redemption of the loans by PT Bentoel Internasional Investama TbK and the subsequent early redemption of the long-term borrowings payable by the Company to Pathway 4 (Jersey) Limited. As a consequence, the long-term loans have been reclassified to receivables in the Balance Sheet. On 24 June 2016 the long-term loans have been repaid in full.

Profit & loss account for the year ended 31 December

All amounts in EUR'000	Notes	2016		2015	
Net sales	12	240,522		213,061	
Cost of sales	13	(137,018)		(110,025)	
Gross margin			103,504		103,036
Selling and distribution expenses	14		(15,545)		(15,588)
General and administrative expenses	15		(124,212)		(112,509)
Net result on net sales			(36,253)		(25,061)
Financial income	16	63,811		87,197	
Financial expense	16	(64,314)		(77,119)	
Net financial result			(503)		10,078
Result before taxation			(36,756)		(14,983)
Taxation	17		5,748		2,123
Result after taxation			(31,008)		(12,860)

Notes to the balance sheet and profit & loss account

All amounts in EUR'000

NOTE 7 – CURRENT LIABILITIES

	31 December 2016	31 December 2015
Trade creditors	6,021	9,331
Current portion of long-term liabilities (refer note 8)	20,802	737,548
Amounts due to affiliated companies	234,550	150,869
Duties and taxes	--	84
Accruals and deferred income	--	131
	261,373	897,963

The amounts due to affiliated companies relate mainly to the purchase of goods. Amounts are unsecured, interest free and payable on demand. The fair value of the current liabilities approximates the book value due to its short-term character, as all current liabilities fall due in less than one year.

NOTE 8 – NON-CURRENT LIABILITIES

	31 December 2016	31 December 2015
IDR 5.3 trillion due 30 June 2016, interest free	--	326,341
IDR 6.7 trillion due 30 June 2016, interest free	--	411,207
Long-term liabilities due to Patway 4 (Jersey) Limited	--	737,548
Long-term revolving credit facility due to an affiliated company	20,802	--

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Office: Gaasterlandstraat 5, 1079 RH Amsterdam, the Netherlands
+31 6 54674124 / www.investigativedesk.com / desk@investigativedesk.com

1.2 Royalties

The mechanism behind royalty payments is similar to that of interest payments. A target entity/subsidiary lowers its taxable base through royalty payments. Usually the company creates some intellectual property right, such as patents, copyrights and trade-marks. The company parks this asset in a subsidiary in a country that has a favourable tax regime with regards to intellectual property, such as Ireland. The subsidiary then grants a license to the target entity and the target entity can now pay royalties to use the license. Subsequently, the royalty incomes are channelled to a low tax jurisdiction. It may be that extra subsidiaries are needed to avoid the payment of withholding taxes on the royalty payments. A notorious construction, used by Google, among others (Guardian, 2020), was the 'Double Irish with Dutch' (see glossary) (Financial Times, 2014).

An indicator and prerequisite for this scheme is, clearly, a subsidiary in a country that offers low tax rates through a patent box (see glossary) (prerequisite). The lower tax entity should report more patents/intangible assets and a higher operating profitability (European Commission, 2017). Obviously, the target entity reports lower (operating) profitability. The deduction of the royalty costs results in a lower operating profit, hence a lower profit before taxation.

An example of royalty payments can be found at Philip Morris Holland BV. In the annual report of 2016, royalty payments can be found in note 19: related parties transactions. They should generally be found in the profit and loss account under expenses (likely in one of the notes, if reported at all). We have not been able to identify (yet) where these royalty payments go.

Another example is the sale of cigarettes produced by BAT Korea Manufacturing Ltd. (South Korea) to Rothmans Far East BV in the Netherlands. The logical endgame is to shift part of this towards a tax haven in the form of royalty payments.

19. RELATED PARTIES TRANSACTIONS

All group companies belonging to the Philip Morris International Inc. group qualify as related party. The parent company Philip Morris International Inc. also qualifies as a related party. Transactions with related parties are agreed on an arm's length basis. Following group structure, no specific securities are in place for receivables and payables.

These transactions are summarised as follows:

Transaction	Income 2016 EUR '000	Expense 2016 EUR '000	Income 2015 EUR '000	Expense 2015 EUR '000
Revenue from tolling activities	63,029	-	67,805	-
Impairment/restructuring recharge		3,014	19,109	-
Sales of finished goods	3,694	-	679	-
Purchase of finished goods	-	101,434	-	97,878
Service Fees	-	4,895	-	5,076
Royalties	-	27,939	-	26,081
Interest income	5,936	-	5,912	-
Other	-	-	153	-

The amounts which are still payable or receivable at year-end are recognised under intercompany payable or receivable. Service fees do include operating costs, overhead and management fees.

1.3 Intra-firm transactions

The strategic pricing of intra-firm cross-border transactions can be one of the most direct channels of tax planning. Multinationals are able to relocate their profits by ‘overpricing’ exports from subsidiaries in higher tax jurisdictions to affiliates in a lower-tax jurisdiction. This general principle applies to all intra-company transactions including payments for the use of intangibles assets or debt payments.

An indicator and prerequisite for this tax planning tool is the presence of a subsidiary in a country with a zero or lower corporate tax rate. This lower tax entity then is engaged in intra-firm sales to a subsidiary in a country with a higher tax rate (the target entity). By strategically pricing this intra-firm transaction, the corporate tax base is relocated from the target entity in the higher tax country to the lower tax entity in the zero/lower tax country. The prices will be set artificially high for imports from zero/lower tax countries or artificially low for imports from the target entity. This results in a higher operating profitability in the zero/lower tax entity and a lower operating profitability in the target entity (European Commission, 2017).

We have identified several relevant Big Tobacco fiscal structures via the Netherlands. An example of intra-firm transactions is the sale of cigarettes produced by BAT Korea Manufacturing Ltd. (South Korea) to Rothmans Far East BV in the Netherlands. On paper, all of the BAT cigarettes produced in South Korea are sold to the company in the Netherlands. Then they are sold back immediately to another Korean company, BAT Korea Ltd, at a much higher price. This way, on average each year €98 million in Korean profits are shifted to the Netherlands.

In addition, this revenue doesn’t end up in the Netherlands. The logical endgame is to shift part of this towards a tax haven in the form of royalty payments.

ROTHMANS FAR EAST B.V.

Management report

INTRODUCTION

The directors submit their annual report for Rothmans Far East B.V. ("the Company"), a private limited liability company under Dutch law and listed under number 33301555 in the Trade Register, with its legal address at Handelsweg 53 A, 1181 ZA Amstelveen, for the year ended 31 December 2018. These are to be presented at the Annual General Meeting of Shareholders to be held on 20 November 2019. The financial statements of the Company are presented on pages 8 to 25.

PRINCIPAL ACTIVITIES

The principal activities of the Company are the distribution, marketing and sale of tobacco and other nicotine products through its branch in the Republic of Korea under the name Rothmans Far East B.V.,152 Teheran-ro, Gangnam-gu, Seoul, resident (corporation) registration number: 110181-0031331 (the "Branch"). The Branch purchases tobacco products from British American Tobacco Korea Manufacturing Limited ("BATKM"), a Korean corporation and affiliated company and sells them to British American Tobacco Korea Limited ("BATK"), also a Korean corporation and affiliated company.

NOTE 11 ~ NET TURNOVER

The net sales are generated by the sales of tobacco and nicotine products, mainly to related parties.

	2018		2017	
South Korea	222,510	100.0%	240,345	100.0%

NOTE 12 ~ COST OF SALES

Cost of sales comprise the costs of products purchased from affilaited companies for EUR 146,228 (2017: EUR 129,305).

1.4 Transfer pricing adjustments

In principle, tax authorities require intragroup transactions to be done at 'arm's length', meaning at a reasonable market value. If two companies engage in intragroup selling at non-arm's length, transfer pricing adjustments can be made to calculate the taxable income. The company whose taxable income increased (because it sold goods and services for a higher than market value price) can claim compensation. Companies who benefited from the transfer pricing must offset this reduction of taxable income from their fellow subsidiaries by increasing their own. Transfer pricing adjustments can be made in relation to management charges, royalties and loan relationships (HRMC, 2014).

Companies use this option to adjust the tax burden of subsidiaries that book losses. I.e. they lower the negative tax on the negative profit. Subsequently, subsidiaries with a positive profit can offset part of their taxable income with the transfer pricing adjustment from the other subsidiary.

Imperial Brands used this scheme by letting the companies with artificial losses make positive adjustments through UK-UK transfer pricing, so that companies with actual profits could claim a reduction.

IMPERIAL TOBACCO HOLDINGS (2007) LIMITED

Notes to the Financial Statements

6. Tax

Factors affecting the tax charge for the year

The tax assessed for the year is lower (2017: lower) than the standard rate of corporation tax in the UK of 19.0 per cent (2017: 19.5 per cent). The differences are explained as follows:

(In £ thousand)	2018	2017
Profit before taxation	1,764,581	404,707
Profit before taxation multiplied by standard rate of corporation tax in the UK of 19.0 per cent (2017: 19.5 per cent).	335,270	78,918
Tax effects of:		
Group relief surrendered	7,904	8,379
UK-UK transfer pricing adjustment	36,826	35,943
Income not subject to tax	(380,000)	(123,240)
Total tax charged to the income statement	-	-

The corporation tax for the year has been adjusted by £7,904 thousand (2017: £8,379 thousand) due to the surrender of group relief for nil consideration to (2017: to) other Imperial Brands PLC companies.

Annual report of Imperial Brands Finance PLC

8. Tax on profit

Analysis of charge in the year:

(In £ million)	2018	2017
Adjustments in respect of prior years	(1)	-
Withholding tax	1	1
Current tax	-	1
Origination and reversal of timing differences	18	7
Deferred tax	18	7
Total tax charge	18	8

Factors affecting the tax charge for the year

Tax for the year is lower (2017: lower) than the standard rate of corporation tax in the UK for the year of 19.0 per cent (2017: 19.5 per cent). The differences are explained as follows:

(In £ million)	2018	2017
Profit before taxation	177	332
Profit before taxation multiplied by standard rate of corporation tax in the UK of 19.0% (2017: 19.5%)	33	65
Effects of:		
Non-deductible loan waiver	-	3
Adjustments to tax charge in respect of prior years (current tax)	(1)	-
Adjustments to tax charge in respect of prior years (deferred tax)	18	(2)
Foreign tax paid	1	1
UK-UK transfer pricing adjustment	(36)	(59)
Group relief surrendered	3	-
Total tax charge	18	8

An adjustment for UK-UK transfer pricing has been included in accordance with the Taxation (International and Other Provisions) Act 2010, Part 4. The corporation tax charge for the year has been adjusted by £3 million (2017: £nil) due to the surrender of group relief for nil consideration to (2017: to) other Imperial Brands PLC group subsidiaries.

1.4 Group relief and fiscal unity

Similar to transfer pricing adjustments, companies use group relief to offset the profits of one subsidiary with the (artificial) losses of another. Some countries, such as the Netherlands, allow for fiscal unity, meaning various subsidiaries can fiscally consolidate their financial results, and are treated as if it were one taxpayer by the tax authorities.

The UK does not have the option of fiscal unity, but it allows 'group relief', which boils down to the same mechanism of tax compensation within a group of subsidiaries (see glossary). We have seen extensive use of this in nearly all British annual reports, especially with BAT and Imperial Brands. The example below is from Imperial Tobacco Altadis Ltd 2018. The reported profit for this entity is £71 million. That would, under the 2018 corporate tax rate, amount to £14 million tax payable. However, this amount is completely offset by an amount of £14 million of received group relief.

IMPERIAL TOBACCO ALTADIS LIMITED

Notes to the Financial Statements

6. Tax

Factors affecting the tax charge for the year
The tax assessed for the year is lower (2017: lower) than the standard rate of corporation tax in the UK of 19.0 per cent (2017: 19.5 per cent). The differences are explained as follows:

(In € million)	2018	2017
Profit before taxation	71	216
Profit before taxation multiplied by standard rate of corporation tax in the UK of 19.0 per cent (2017: 19.5 per cent).	14	42
Tax effects of:		
Group relief claimed	(14)	(42)
Total tax charged to the income statement	-	-

The corporation tax credit for the year has been adjusted by €14 million (2017: €42 million) due to the claim of group relief for nil consideration from (2017: from) other Imperial Brands PLC companies.

2. The routes: the main countries facilitating tobacco tax avoidance

The four tobacco companies realize their profits in virtually all countries of the world. It is therefore unsurprising that they have subsidiaries in multiple countries. Imperial Brands, for example, reports as many as 250 subsidiaries globally. To a large extent, the profits from these subsidiaries are channelled to 'ultimate beneficial owners' in tax havens like the British Virgin Islands or Bermuda.

It is not easy to get information about the money flows to these tax havens. However, in the lists of subsidiaries reported by the tobacco companies, addresses in these tax havens still show up. Imperial Brands, for example, reports ITB Corporation Limited, a trademark owner in the Bahamas.

In the databases of the International Consortium of Investigative Journalists ICIJ, registrations in tax havens can be found for subsidiaries of all four companies. PMI International Ventures Ltd., for example, is registered in Saint Kitts and Nevis. Altadis International limited, a IB subsidiary, is registered in the British Virgin Islands, and linked to Cyprus. Weston, a subsidiary of BAT, has multiple registrations on the British Virgin Islands, Panama and some older ones on the Bahamas, with connections to Switzerland, Luxembourg and Guernsey.

Most of these registrations date from before 2010, but a few still existed in 2014 (the final year in the ICIJ databases) so there's a chance that at least part of the avoided tax moneys still end up in one of these tax havens.

To gain more insight in the structures used by the tobacco industry to channel money to tax havens, it is useful to first focus on the European countries that facilitate these international fiscal schemes. Because of their relative transparency, more information can be obtained in these countries than in the tax havens themselves. The Tax Justice Network (2019) has developed an index to rank countries on the favourability of their tax regimes for tax avoidance. A higher number indicates more potential for avoidance. The highest ranking European countries in this index are the Netherlands [with an index score of 2390], Switzerland [1875], Luxembourg [1794], Ireland [1363], the UK [1067], and Belgium [822] (Tax Justice Network, 2019).[2]

It is likely that the big tobacco companies use these countries for their tax planning strategies. Indeed, we found subsidiaries of all four companies in all of these countries (in this analysis we are excluding the British overseas territories). Below, the main appealing features of the tax regimes of these countries are described, and these are illustrated with examples we found in the financial data.

[2] The UK's (former) overseas territories are ranked separately, e.g. Jersey scores 1541, and the - first ranking - British Virgin Islands scores 2769.

The Netherlands

The Netherlands has a corporate tax rate of 25 percent of profits made by Dutch companies worldwide. However, it does not levy withholding tax on interest and royalties. It does have a 15 percent withholding tax on dividends (Deloitte, 2020). However, it has many tax treaties that arrange dividend tax bilaterally. Furthermore, it offers a favourable tax ruling regime.

A 2019 report by the CPB Netherlands Bureau for Economic Policy Analysis, a government agency, explains the origin and destination of dividend, interest, and royalty flows passing through the Netherlands. It finds that Bermuda is the most important destination for royalty flows. The money flows come from Ireland, Singapore and the United States. The origins of dividend and interest payments are more widespread (Lejour, Möhlmann, van't Riet & Benschop, 2019).

Dividends

All four transnational tobacco players have established holding companies in the Netherlands to shift dividends, which are in effect profits from foreign subsidiaries. Dividends are used to repatriate profits to their final destination; the ultimate beneficial owner. Due to the large number of tax treaties the Netherlands has with other countries, these dividends are usually free of tax charge in the Netherlands. In general, these profits have been taxed in the country in which they were realized.

On average, Tobacco's Big Four shift around €7.5 billion of worldwide profits through the Netherlands annually, in the form of dividends. British American Tobacco and Imperial Brands move these dividends on to holding companies in the UK, Philip Morris International to a holding company in Switzerland. Japan Tobacco International seems to send the dividends involved via the Netherlands straight to the parent company in Japan.

In many countries, these profits would be subject to withholding tax. But thanks to the tax treaties the Netherlands has arranged with numerous other countries, these dividends are generally free of withholding tax in the country where the profit was made, and free of any withholding or dividend tax in the Netherlands. In other words: after the first amount of corporation tax has been paid, these profits are never taxed again. If these profits were sent directly to the UK, for example, in many cases they would have been charged with a withholding tax (of 5-20 percent) in the country of origin.

In 2020, Dutch investigative group SOMO concluded the large amount of Dutch tax treaties favours multinationals, and harms developing countries in particular (SOMO, 2020b). The Dutch government is planning to introduce a withholding tax on foreign dividends in 2024, to stop this form of legal tax avoidance.

It is hard to estimate the exact amount of tax that is avoided by shifting dividends through the Netherlands, if not impossible. We would have to know all the local tax rates of the countries where the profits are realized, as well as the withholding tax the companies would have had to pay if they didn't shift their profits through the Netherlands. These percentages vary in each country. The annual accounts of Dutch subsidiaries usually mention the amount of foreign dividends being shifted, but unfortunately they don't specify these cash flows country-by-country. If all countries applied a 10 percent withholding tax, which seems common/typical, the level of profits moved through the Netherlands suggests this would equate to €750 million in forgone taxation.

Royalties

We have identified several other Big Tobacco fiscal structures via the Netherlands. An example of intra-firm transactions (transfer pricing) is the sale of cigarettes produced by BAT Korea Manufacturing Ltd. (South Korea) to Rothmans Far East BV in the Netherlands. On paper, all of the BAT cigarettes produced in South Korea are sold to the company in the Netherlands. Then they are sold back immediately to another Korean company, BAT Korea Ltd,at almost always double the price. This way, each year tens of millions in income are shifted to the Netherlands from South Korea. The logical endgame would be that Rothmans Far East then shifts this income towards a tax haven, in the form of royalties. This route saves BAT millions of annual income tax in South Korea. The corporate tax rate in South Korea is progressive from 10 percent on the first 100 billion KRW (+/- £65 million) up to 25 percent on a taxable income > 300 billion KRW (+/- £200 million) (Deloitte, 2019). So even though the corporate tax rate in South Korea is only somewhat lower than in the Netherlands, the profits are channelled through the Netherlands for it to end up in a low tax jurisdiction. The tax authorities of South Korea currently claim £53 million from BAT for tax avoidance.

We have found PM Holland BV annually pays between €25 and 29 million in royalties to a foreign entity. For the Dutch BV these are costs, so the taxable profit is lowered considerably. Again, the logical endgame would be to shift the profit towards a jurisdiction where the rate of corporate tax is (near) zero.

Japan Tobacco International Group Holding BV reports between 2010 and 2013 that it shifts about €250 million annually through the Netherlands in the form of royalties. After 2013 they stopped reporting the royalty payments, and less information is provided in the annual accounts. It is, however, likely this subsidiary continued to function as a conduit using royalty payments. These are indicators that PMI and JTI also use royalty payments (through the Netherlands), as a tax planning tool.

Internal financing

Big Tobacco uses financing companies in the Netherlands to give loans to foreign and local subsidiaries. These loans can have a concrete purpose - for example financing the building of a new factory - and/or they can be given solely for bringing down profits in the subsidiary country via the interest payable on the loan.

A clear example of the latter is, as mentioned above, a loan Rothmans Far East BV in the Netherlands granted to Bentoel Internasional, a subsidiary in Indonesia. A total of $963 million was granted in the years 2013-2016, with an interest rate of between 9 and 11.75 percent. A total of $164 million dollars flowed from Indonesia to the Netherlands, as interest on this loan. Rothmans Far East then paid out this interest to a parent company in (tax paradise) Jersey, Pathway 4 Ltd, which financed the loan in the first place. This way, taxable profit in Indonesia was lowered by tens of millions of dollars. In 2016 the loan was suddenly repaid. BAT declined to specify why.

In much the same way, Philip Morris Investments BV receives between €30-54 million each year in interest on loans to group companies. This revenue doesn't stay in the Netherlands, it appears to be shifted to the parent company in Switzerland.

Between 2010-2013, Japan Tobacco International shifted amounts of €16-59 million a year in interest over loans granted by the Dutch holding company. The interest was shifted further to the parent company in Japan. This is a strong indication of base erosion and profit shifting through interest payments. It is difficult to determine whether these loans are indeed only used for profit shifting. The interest rates could be set at arm's length. However, the volume of the loan can in that case still be unproportionally extensive for actual investment purposes. Whether the loan is proportional would depend on the substance of the receiving subsidiaries, which, for an external researcher, is difficult to determine.

Imperial Brands does not publish a lot of financial information in the Netherlands, as most subsidiaries only provide the consolidated annual report of the ultimate parent. Most subsidiaries did not file an annual report at the Chamber of Commerce. The documents we did manage to access did not contain information about financial liabilities or financial assets. So we did not identify internal loan structures in the Netherlands.

The United Kingdom

As a tax facility, group relief exists to stimulate companies to invest in developing new business and innovations - as long as these are loss making, a company can deduct the losses from their taxable profits. The tobacco companies have recently been investing in new developments, like vaping. These activities are usually being deployed in new entities, apart from the existing tobacco business.

Our research shows the British tobacco giants in particular make use of group relief. Imperial Brands lowered its corporate tax bill by an estimated £1.8 billion over the last 10 years. BAT lowered theirs by over £760 million. Furthermore, our research suggests this relief doesn't always originate from investments in innovations or other loss-making activities. At both IB and BAT, part of the losses of their subsidiaries originate from interest paid on internal loans, resulting in eligibility for group relief. By using these internal structures, the tobacco giants may be creating artificial losses that, by way of using group relief, ultimately lower their tax bill (to confirm such artificiality requires further research).

Both BAT and IB register large amounts of group relief each year: they deduct losses in foreign subsidiaries from corporation taxes payable in the UK. For BAT, this amounts to around £70 million group relief each year, registered in three holding companies: BAT International Finance, BAT UK and Exports Ltd, and BATIF Dollar Ltd. As a result, BAT as a whole pays close to zero tax in the UK, according to their books.

Imperial Brands applied group relief in such a way that it lowered the tax burden of its British subsidiaries by about £1.8 billion over ten years.

Internal financing

Via financing companies BAT International Finance Ltd., JTI (UK) Finance Ltd., and IB Finance plc, BAT, JTI and IB give (internal) loans to group subsidiaries, for which these subsidiaries pay large amounts of interest. For BAT and IB, the amount of annual interest on these loans exceeds €1 billion. Japan Tobacco International also finances a small part of their business from the UK, via subsidiary Gallaher Ltd. The amount of interest received is between €25-78 million (annually).

In case these financing companies pay out interests comparable to the amounts they receive, the internal loans are likely financed with bank loans with the same interest rate ('at arm's length').

Imperial Brands makes extensive use of internal loans. The British subsidiary Imperial Brands Finance plc plays a central role in the channelling of interest payments. Over the last ten years it reported £8.8 billion interest payable, and £16.6 billion interest receivable, most of which were entered as 'amounts owed/receivable from group undertakings'. This is a strong indication that Imperial Brands uses interest payments to lower its tax burden. However, since the company does not report in which countries or at which subsidiaries it has the outstanding loans, we have not been able to identify the full chain of payments.

Subsequent research in the annual accounts of IB's British subsidiaries that surrender group relief did provide evidence that all losses in the books arise from interest payments on internal loans (after deducting dividend incomes from taxable income). The interest rates seem to be at arm's length, but we haven't been able to identify repayments of the loans nor any entries on the profit & loss or balance sheets that indicate that the loans are actually used for investments.

For BAT this is a bit more complicated. Similarly to IB, losses in the books arise from interest payments on internal loans. However, from analysing the financial liabilities in the annual accounts, it seems that at least part of them are actually used for investments in other subsidiaries, although the destination of the loans and the nature of the investments involved is not always clear.

Philip Morris International doesn't seem to use the British fiscal system for reasons of tax avoidance. PMI shifts the majority of their profits to a holding company in Switzerland, mostly via holding companies in the Netherlands.

Belgium

Up until recently, the most important tax benefits in Belgium were the excess profit rulings, the notional interest deduction system, and the patent box, which is a tax benefit on income from intellectual property (see glossary of definitions).

In 2018, this situation changed as all three strategies were restricted (Deloitte, 2020). However, as a compensation, the government has lowered the corporate tax rate from 34 percent to 29 percent, with possible deductions.

Philip Morris International in particular uses the Belgian fiscal facilities. The local holding company PMI Benelux BVBA buys cigarettes from Dutch sister company PM Holland BV and immediately sells them back (for a higher price) to this very same company. As it is stated in the annual report of PM Holland 2014: "The Company is the licensee for the Dutch market, accordingly tobacco products (cigarettes, fine-cut and tubes) are sold to PM Benelux BVBA and repurchased for the Dutch domestic market to sell the products to the Dutch customers."

As a result, PMI Benelux BVBA registers annual income of €2.8 to €3 billion each year. The Belgian entity pays less than 10 percent corporation tax over this income annually over the years 2010-2018 (2019 is not available).

In 2014, PMI had a legal conflict with the Belgian tax authorities over the sale of the Mexican subsidiary to another group company in the Netherlands: "The Company, as former shareholder of Philip Morris Belgium Holdings B.V.B.A. has received a tax assessment relating to the intercompany sale of Mexican Investment. On May 27, 2014 the Company has paid €137,105,979 to the Belgium Tax authorities. The principal includes 7 percent interest and will be refunded by the Belgian State."

PMI then won this dispute in a Court of Appeal: "Following the pleadings in appeal that took place on May 29, 2017, the Court of Appeal of Antwerp ruled on June 22, 2017 in PM Investments BV favour, reversing the judgment of the Court of first instance." This lawsuit illustrates that it is very difficult to prove that companies engage in transfer pricing at non-arm's length.

British American Tobacco uses the notional interest facility in Belgium. BAT has parked around €3.5 billion in assets in three holding companies in Belgium, which from 2010-2017 helped them deduct several millions in notional (fictitious) interest each year. The notional interest deduction diminished over the years and ended in 2018. Details of this use of the notional interest facility need to be subject of further investigation.

BAT shifts around €1 billion in dividend via Belgium each year. Tax paid on these profits is less than 1 percent. In September 2019, the European Commission said it opened an in-depth investigation into tax avoidance by multinationals. BAT is one of the 39 companies under investigation.[3]

The Belgium subsidiary most likely functions as a conduit. We have not identified where the dividends are channelled from Belgium.

JTI and IB don't seem to use the Belgian tax facilities in a very significant way.

Switzerland

Since companies registered in this country are not obliged to publish financial reports, data for Switzerland are hard to find. We haven't been able to examine any Swiss accounts of tobacco companies.

We did find a few interesting leads, however, especially concerning Philip Morris International. We found indications that a large part of PMI's annual profits are shifted towards Swiss entities, mainly from holding companies in the Netherlands. The Dutch holding companies all have a parent company in Switzerland with several financial ties back and forth. For example, raw materials for tobacco production in the Netherlands are bought from Switzerland. From 2010 up to 2017, PMI Investments BV paid €30-54 million of interest per year on a €10 billion loan granted by Philip Morris Brands sarl, Switzerland. Furthermore, royalties of €24-28 million paid by PM Holland BV each year end up in Switzerland.

[3] Press release European Commission, 20 September 2019, retrieved from https://ec.europa.eu/commission/presscorner/detail/en/ip_19_5578, 21 October 2020.

Annually, several billion euros in dividends seem to end up in Switzerland via the Netherlands. In 2014, the Dutch financial newspaper FD reported that PMI parked 55 percent of their worldwide activities in Dutch subsidiaries, all of which had a Swiss parent company.

In addition, an Irish holding company (PMI Insurance Ireland Ltd.), also shifts its dividends towards the Swiss parent company Philip Morris Brands sarl.

The Swiss branch of PMI also uses a 'cash pooling system' and a 'tolling system' with subsidiaries in other countries (see glossary of definitions). Under the tolling system, Dutch manufacturing company PM Holland BV buys raw materials from Philip Morris Brands sarl on paper, while revenue from sold products seems to be directed to Switzerland immediately. If the price the Dutch entity pays for these materials to their Swiss counterpart is artificially high, profits in the Netherlands are lowered, resulting in tax avoidance in the Netherlands. The exact importance of this route needs further investigation.

For the other tobacco multinationals, we lack the data to conclude anything on their use of the Swiss tax facilities.

Luxembourg

Luxembourg does not levy withholding tax on interest or royalties. Dividends paid to a non-resident company are generally subject to a 15 percent withholding tax, unless the rate is reduced under a tax treaty. Luxembourg has a broad network of income tax treaties (double taxation treaties). No tax is withheld on dividends paid to a qualifying company under the EU parent subsidiary directive. These benefits could be extended to non-EU tax treaty countries if the conditions are similar to those under the Luxembourg participation exemption and the parent company is subject to a tax similar to the Luxembourg corporation tax (Deloitte, 2020).

We found some indications that Imperial Brands may make use of the exemption of withholding tax on incoming royalty and interest payments. The Luxembourgian subsidiary company Altadis Luxembourg SA received on average €6 million of royalty income from the UK until 2015, and €2 million afterwards. Imperial Tobacco Management Luxembourg (3) sarl, another subsidiary, also structurally receives €100 million on interest payments.

These amounts in themselves are too small to suggest large-scale tax avoidance. However, it is possible that we have not been able to identify all royalty payments to Luxembourg or other countries, as often these payments are not explicitly mentioned under a separate entry in the profit and loss account.

British American Tobacco held an unknown share in Luxembourg-based Landewyck Group, a cigarette-producing company with six factories across Western Europe and a turnover of several billion euros annually. In 2018, BAT sold their interest in Landewyck Group, as mentioned in BAT's annual report 2018. The reason for this is unknown and will be subject of further investigation. Apart from this divested share in Landewyck, BAT has a limited presence in Luxembourg.

PMI and JTI make very limited use of Luxembourg as well. They both operate a local company with limited turnover.

Ireland

The Irish corporate tax rate is 12.5 percent for trading income. Dividends paid to other Irish companies are exempt from withholding tax. Dividends paid to non-resident companies are, in principle, subject to a 20 percent withholding tax. The same rate applies to royalties and interest. However, Ireland has a favourable tax treaty system, and it is likely that all three rates are reduced under a tax treaty, or the dividends may be exempt from withholding tax under the EU parent-subsidiary directive. A final important aspect of the Irish tax structure is the tax relief provided for the investment in intellectual property. These can be expenditure on intangible assets, such as brands, copyrights and trade names (Deloitte, 2020).

It is for the latter reason that large companies such as Apple and Google have established their headquarters in Ireland. They subsequently make use of the so-called 'Double Irish with Dutch'. This tax avoidance scheme involves parking intellectual property rights in Ireland, then sending profits as royalties through the Irish company, then to a Dutch company and finally to a second Irish company headquartered in a tax haven with a lowcorporate tax rate (see glossary).

As yet, we have found no conclusive evidence that the big four tobacco companies are using this scheme too. We only found some, non-conclusive, indications of an Irish - Dutch connection for Imperial Brands:

ITOH Dutch branch holds €2.5 billion liabilities at (borrows from) Imperial Tobacco Ireland and Imperial Tobacco Overseas ltd (UK), at an interest rate of about 5 percent. Imperial Tobacco Ireland Unlimited received on average €45 million of interest income until 2017. Newglade International, another Irish subsidiary of Imperial Brands, received on average €20 million yearly. After 2017 this amount dropped and high amounts of dividends were paid. Neither companies reported any interest or royalties payable. However, both hold a large amount of fixed assets (about €800 million and about €350 million respectively). It was not specified what these assets are; possibly they contain large amounts of intellectual property.

We did find that Philip Morris makes extensive use of the Irish route as large dividends and interest payments flow through PMI Insurance Ireland Ltd to, among others, Switzerland.

BAT and JTI both operate a local business in Ireland, with limited revenues. In view of their tax policies, this would warrant further research as to whether they are using the Irish route to dodge taxes.

2. The companies: the hierarchical structure of subsidiaries, the associated dividend flows and tax disputes

This section aims to map the internal structure of the four major tobacco companies. In a series of figures (see annex) we attempt to visualize the hierarchical structure of subsidiaries of the companies. This may be helpful to trace the dividends flows and see internal connections. Dividend payments are used to shift profits around and move them towards the ultimate beneficial owners. Furthermore, the internal connections may give some insights in the infrastructures that could potentially be used for other tax planning tools, such as internal loans and group relief.

Philip Morris International

Subsidiary & dividend structure

See appendix

Tax avoidance structures:

Dividends:

Philip Morris uses dividends to shift profits, likely ultimately to countries with a low to zero corporate tax rate.[4]

For instance, Latin America and Canada Investments B.V. has up to €3 billion in total assets and the shareholders equity amounts up to €1.85 billion. Furthermore, in 2010-2013 the company received dividends for a total amount of more than €1.4 billion in dividends. Yet, its annual profit is just up to €350,000, while turnover, or sales revenue, amounts to zero. These are strong indicators that this subsidiary is a conduit through which large sums of money are channelled, without there being actual production or sales of goods. I.e. The subsidiary lacks substance and is a mere letterbox company, used to facilitate the channelling of money.

Dumas BV makes up to €160,000 profit, all of which is dividend income. All of the shareholders equity consist of investments in PM Mexico S.A. de C.V, of which it owns 80 percent of the shares (the total amount of investments of PM Mexico SA de CV is €854 million, annual report 2014). Over the years we investigated, Dumas BV has received up to €165 million annually in the form of dividends (mostly from Mexico).

Philip Morris Investments BV also receives dividends from various other subsidiaries, with a total value up to €2 billion. The largest dividend income comes from PTPM Indonesia (over €700 million) and PM Izhora in Russia (over €400 million). Philip Morris Brands Sarl, based in Neuchâtel, Switzerland, is main shareholder of Philip Morris Investments BV.

Philip Morris Investments BV acts as a holding company for its subsidiaries. During 2017, its activity as a trading company for the purchase and sale of raw materials and finished products destined for the Libyan market has been taken over by a different Swiss Philip Morris Company.

[4] Since we have no access to annual reports in Switzerland, we cannot determine the final destination.

Internal loans and Cash Pooling

Philip Morris uses a so-called cash pooling systems to arrange internal loans to a group of companies. For instance, Philip Morris BV (the Netherlands) receives up to hundreds of millions of euros annually as a result of various intercompany financial transactions, including from a cash pooling system. The amounts due from group companies include a cash pool amounting to almost €270 million (2017: more than €100 million). Interest rates seem to be set at arm's length; therefore we cannot say it is illegal. Still, the large size of the loans is an indicator that the loans may not be used for actual investment in production facilities. If the size of the loan is large enough, interest payments can be used to shift profit, even at arm's length. Again, this is difficult to prove. It is clear that the interest payments could be used to depress taxable income and shift profits from other subsidiaries.

Philip Morris Investments BV makes use of a similar tax planning scheme. Between 2010 and 2018, the company received up to tens of millions of euros as a result of various intercompany financial transactions with cash flows up to €100 million; including short- and long-term loans granted to the parent company and various subsidiaries. For example: On June 15, 2013 a long-term loan receivable (date to maturity > 1 year) of €100 million was granted to Papastratos Cigarette Manufacturing Company S.A. for an indefinite period. The loan is free from interest. The amount is paid back in 2015. Further research is needed to find out why this money is moved around between subsidiaries, seemingly without any cost (nor benefit).

Philip Morris is also engaged in a cash pooling system with the parent company, Philip Morris Holland BV, and Philip Morris Finance SA, based in Switzerland. The interest rate basis under the agreement is defined as short-term EONIA plus / minus 0.25 percent. The cash flows amount up to €1 billion.

Between 2010 and 2018, Philip Morris CR, a Czech subsidiary, was engaged in various intercompany financial transactions with its parent company Philip Morris Finance SA in Switzerland, including loans and deposits (interest-bearing on-demand deposits/cash pool system). In the annual reports, each subsidiary is mentioned by name. This is a possible lead for follow-up research.

Latin America and Canada investments BV annually grants intercompany short-term loans with a total amount of more than €1 billion.

PMI subsidiaries in Ireland also use internal loan structures to move around profits. The main shareholder of PMI Insurance Ireland Limited is Philip Morris Brands Sarl (Switzerland). In 2013, the reserves at Jan 1 were paid out as dividend (to the Swiss parent). The stated principal activity of the company was insurance business with respect to the risks of group companies. It engages in various intercompany financial transactions with the parent company and subsidiaries, including a cash pool system with a cash flow of over €57 million.

Tolling system and royalty payments

Philip Morris made use of the tolling system as a base erosion strategy at least until 2014. This entails internally selling semi-finished products. The annual report does not explain what these semi-finished products are. We found such a system at Philip Morris Holland BV which converts raw materials into semi-finished products and ingredients. Annually, the company makes a couple of hundred million euros in revenue, and over €100 million in profit. It also pays up to €30 million in royalties.

Between 2010 and 2018, Philip Morris Benelux BVBA had up to €3 billion in revenues annually, while the profits were no more than €5.1 million. There is hardly any difference between the applicable and effective tax rate. This might be explained by the fact that these revenues mostly contain foreign dividends, which are free of tax charge under Belgian law.

Group relief

Philip Morris reports group relief through fiscal unity. For instance: as of 1 January 2011, Philip Morris Holland Holdings B.V., is head of the fiscal unity (ultimately liable) including the Dutch subsidiaries.

Tax disputes

Various tax claims were filed against Philip Morris over the last ten years. The 2019 annual report of the parent company mentions examinations by foreign tax authorities in major jurisdictions, including Germany (2015 onward), Indonesia (2014 onward), Russia (2017 onward), Switzerland (2017 onward), and Turkey (2014 onward).

- The tax claim in Russia involves an excise dispute with the Moscow Tax Inspectorate for Major Taxpayers ("MTI") which conducted an audit of AO Philip Morris Izhora ("PM Izhora"). In August 2019, PM Izhora submitted its objections disagreeing with MTI's allegations set forth in the initial assessment and MTI's methodology for calculating the alleged underpayments. MTI accepted some of PM Izhora's arguments and in September 2019, issued the final tax assessment claiming an underpayment of RUB 24.3 billion (approximately $374 million). PM Izhora has until mid-September 2020 to challenge the final tax assessment to the Federal Tax Service and is considering whether to appeal.

- Philip Morris Investments BV has also received a tax assessment relating to the intercompany sale of a Mexican Investment. On May 27, 2014 the company paid €137,105,979 to the Belgium Tax authorities. In appeal, however, the Belgian State lost this case and had to pay the money back to PMI.

- Another identified lawsuit is about an alleged underpayment by Philip Morris (Thailand) Limited ("PM Thailand") of customs duties and excise taxes relating to imports from the Philippines covering the period 2003-2007 for a claim of $2.58 billion. In November 2019, the trial court found this subsidiary liable of under-declaration of prices and imposed a fine of approximately THB 1.2 billion (approximately $38.4 million). The trial court dismissed all charges against the individual defendants. In December 2019, the subsidiary paid the fine, but announced that it will appeal the trial court's decision. If the subsidiary ultimately prevails on appeal, then Thailand will be required to return this payment.

- The South Korean Board of Audit and Inspection has investigated whether inventory changes by cigarette companies like Philip Morris Korea Inc. complied with the country's tax laws in the run up to a Jan. 1, 2015, cigarette tax increase. According to the tax authority, PM Korea had transferred its inventory to a temporary warehouse during the September-December 2014. Though the actual sales for these products took place later in 2015, the inventory records were marked as end-2014, shortly before the cigarette tax increase took effect (Korea Herald, 2018). The audit assessed PM Korea underpaid tax. PM Korea state in its 2018 annual report that it paid approximately KRW 272 billion (approximately $227 million), which it deems to be compliant with the Korean tax law.[5] PM Korea appealed the assessments. In January 2020, a trial court ruled that PM Korea did not underpay the approximately KRW 218 billion (approximately $182 million) in taxes that were subject to its jurisdiction. The tax authorities have appealed this decision.

[5] The annual report 2018 also states: "the tax authorities have also referred the matter to the Public Prosecutor. On June 19, 2018, the Public Prosecutor decided not to file criminal charges against PM Korea and/or other alleged co-offenders. The Public Prosecutor also decided not to prosecute PM Korea and its managing director in connection with a criminal complaint against them".

British American Tobacco

Subsidiary & dividend structure

British American Tobacco holds over 200 subsidiaries all around the world. A couple of subsidiaries play a crucial role in their internal structure. The parent company British American Tobacco P.L.C. has three directly-owned subsidiaries, as visualized in the appendix.

British American Tobacco (1998) is the gateway to the countries we're analysing: Belgium, the Netherlands, Ireland, Switzerland and Luxembourg. Only B.A.T. Netherlands Finance B.V. and B.A.T. Finance B.V, both Dutch subsidiaries are directly-owned by B.A.T. International p.l.c..

Dividends can be traced from the 'lowest' subsidiaries all the way up to the big, crucial ones.

Tax avoidance structures

Internal loans

Interest payments are an effective base erosion and profit shifting tool, as they reduce local profits, which results in tax avoidance. The "gateway" (conduit) subsidiaries, which collect the dividends from the smaller ones, pay and receive a lot of interest. These payments eventually result in a manufactured intra-group debt as described later on. Further investigation is necessary to get a hold on the exact way this system functions and the exact substance of these subsidiaries.

In 2014 the BAT group set up subsidiary British American Tobacco (NPG) Limited. This new subsidiary sold their shares to BAT (1998) limited and used the money to invest in Nicoventures Holdings Limited (NHL), a subsidiary that invests in the other Nicoventures subsidiaries in the UK.

Group relief

BAT uses a manufactured intra-group debt to reduce their corporate tax liability. The group's overall external debt is less than £0.5 billion; however, we have identified intra-group lending arrangements showing interest income and expenses higher than £0.5 billion. For example, B.A.T. Industries p.l.c., British American Tobacco (2009) Limited and Weston 2009 Limited pay significant interest payments on intra-group debt. These payments result in losses which are group-relieved to other UK group companies ("group relief surrendered for nil consideration"), which enable them to reduce their corporation tax liability.

Royalties

BAT uses royalties and other vague expenses to reduce their profits. E.g. British American Tobacco Western Europe Region B.V. paid significant intra-group royalties which reduced their profits before tax. This entity also paid significant global service fees in 2014, 2015 and 2016 (after that annual reports are not available). It is unclear to which entity this royalty and these global service fees were paid.

Rothmans Far East B.V. purchases all its tobacco products from a South-Korean subsidiary (€146,288,000) and resells them directly to another South-Korean subsidiary for a much higher price (€222,510,000). The profit stays tax-free in the Netherlands due to the absence of withholding tax and is possibly paid as royalties or non-branded expenditures to a tax haven.

Tax disputes

There are various legal and regulatory actions, proceedings and claims against British American Tobacco related to their tax structures. Among these:

- The Brazilian Federal Tax Authority has filed a claim of €330 million against Souza Cruz seeking to reassess the profits of overseas subsidiaries to corporate income tax and social contribution tax.
- The Dutch tax authority has issued a number of assessments on various issues across the years 2003-2016 in relation to various intragroup transactions. The assessments amount to an aggregate net liability across these periods of £921 million covering tax, interest and penalties.
- British American Tobacco Egypt LLC is subject to two ongoing civil cases concerning the imposition of sales tax on low-price category brands brought by the Egyptian tax authority for £113 million.
- In 2016, the Board of Audit and Inspection of Korea ("BAI") concluded its tax assessment in relation to the 2014 year-end tobacco inventory, and imposed additional national excise, local excise, VAT taxes and penalties. This resulted in the recognition of a KRW 80.7 billion (approximately £53 million) charge by Group subsidiaries, BAT Korea Ltd., Rothmans Far East B.V. Korea Branch Office and BAT Korea Manufacturing Ltd.

Imperial Brands

Subsidiary & dividend structure:

Imperial Brands holds many subsidiaries and the internal structure is intricate.[6]

In order to grasp the main hierarchy, we visualized it in the appendix.

It seems that all dividends of the subsidiaries we analysed are flowing through Imperial Tobacco Holdings (2007) ltd.

Imperial Tobacco Overseas ltd is the entryway to overseas and Irish subsidiaries. It has a branch, or sister company, in the Netherlands. From there connections with the Netherlands are established, between the Netherlands and the UK, and subsidiaries in other countries. Dividends can clearly be traced to arise overseas and to move all the way up the subsidiary 'tree'. It seems the largest subsidiaries in Luxembourg fall directly under the parent company.

IMPERIAL TOBACCO INTERNATIONAL LIMITED

Notes to the financial statements (continued)
For the year ended 30 September 2015

6 **Tax on profit/(loss) on ordinary activities**

Analysis of charge for the year	2015 €000's	2014 €000's
UK Corporation tax at 20.5% (2014:22%)	9,739	(1)
Overseas tax	3,429	3,482
Prior year adjustment - UK and overseas	9,052	(3,778)
Total current tax	22,220	(297)
Current year charge UK	453	(214)
Current year charge overseas	-	2,648
Prior year adjustment	(5,753)	1,191
Effect of change in future tax rates	(11)	19
Total deferred tax	(5,311)	3,644
Tax on (loss)/profit on ordinary activities	16,909	3,347

Factors affecting the current tax charge for the year

The tax assessed for the year is higher (2014: lower) than the standard rate of corporation tax in the UK (20.5%) (2014: 22%). The differences are explained below:

	2015 €000's	2014 €000's
Profit/(loss) on ordinary activities before taxation	15,021	30,836
Profit/(loss) on ordinary activities multiplied by average enacted standard rate of corporation tax in the UK of 20.5% (2014: 22%)	3,079	6,765
Effects of:		
UK-UK transfer pricing adjustment	(243)	(171)
Group relief	8,708	(3,424)
Difference in tax rate on German earnings	1,037	1,991
German loss not subject to UK tax	-	-
Utilisation of prior year losses	-	(2,648)
Other permanent and disallowable items	1,040	754
Prior year adjustment to German tax	11,619	-
Prior year adjustment to UK tax	(2,567)	(3,778)
Current year deferred tax	(453)	214
Current tax charge for the year	22,220	(297)

[6] The arrangement of subsidiaries was subject to change over years. Furthermore, in some instances it was not completely clear which company was the direct parent of another. Figure 2 should thus be interpreted to give an impression of the structure, not to represent a completely accurate display of the concern relations.

Imperial Tobacco limited, Imperial Tobacco International limited, and Imperial Tobacco Enterprise Finance Limited, three large subsidiaries of IB, do report corporate tax in their profit and loss accounts, up to £82 million annually, up to a total of approximately £470 million over the past ten years. However, upon closer look in the notes, it seems these amounts are not actually paid, but used to surrender group relief elsewhere in the group, or to make prior year adjustments. It is therefore difficult to track the actual payments of corporation tax. An example of this is given above.

Tax avoidance structures:

Internal loans

Internal loans are used on a large scale. The top subsidiary Imperial Tobacco Holdings reported on average €420 million interest payable and no interest receivable. Imperial Tobacco Management Luxembourg (3) sarl, for instance, structurally receives €100 million. Imperial Brands Finance PLC also plays an important role in this respect.[7] It holds both financial assets and liabilities of Imperial Tobacco Overseas Holdings Dutch Branch and it seems to both receive from and pay money to Dutch subsidiaries through the interest on internal loans. In 2017, ITOH Dutch Branch entered €10 million as interest receivable from IB Finance PLC, plus €130 million 'cash funding' used for yearly interest payments[8].

Furthermore ITOH Dutch Branch holds financial liabilities (borrowings) of €2.5 billion (from) Imperial Tobacco Ireland and Imperial Tobacco Overseas ltd (UK), at an interest rate of around 5 percent. From 2016 onward, some subsidiaries no longer reported interest payable/ receivable but large fair value gains/losses on financial assets. E.g. Imperial Tobacco Overseas ltd. We suspect this may have to do with the introduction of the BEPS guidelines, though further research must investigate/find out/determine whether this is indeed the case.

In order to establish whether these loans are actually used for investments, we tried to trace the financial liabilities in the accounts of all subsidiaries that surrender group relief. For instance, for IT Holding (2007) limited, the top British subsidiary, reports a financial liability 'amounts owed to group undertakings' on its balance sheet that grow from £2.5 billion in 2010, to £11.5 billion in 2016. Between 2016 and 2019 the post remained stable. In other words, not much seemed to happen with the loan. See the entries below:

IMPERIAL TOBACCO HOLDINGS (2007) LIMITED

Balance Sheet
At 30 September

(In £ thousand)	Note	2019	2018
Fixed assets			
Investments	8	**18,849,997**	18,849,997
Current liabilities			
Creditors: amounts falling due within one year	9	**(11,867,911)**	(11,618,363)
Current liabilities		**(11,867,911)**	(11,618,363)
Total assets less current liabilities		**6,982,086**	7,231,634
Net assets		**6,982,086**	7,231,634
Equity			
Called up share capital	10	**10,930**	10,930
Share premium account		**6,932,996**	6,932,996
Retained earnings		**38,160**	287,708
Total equity		**6,982,086**	7,231,634

The notes on pages 8 to 37 are an integral part of these financial statements.

For the year ending 30 September 2019 the Company was entitled to exemption from audit under section 479A of the Companies Act 2006 relating to subsidiary companies.

[7] The annual report of IB Finance plc of 2018 contains a lot of information about the specific loans and financial derivatives they use.
[8] See annual report of the ITOH Dutch Branch 2017

IMPERIAL TOBACCO HOLDINGS (2007) LIMITED

Notes to the Financial Statements

9. Creditors: amounts falling due within one year

(In £ thousand)	2019	2018
Amounts owed to group undertakings	**11,867,911**	**11,618,363**

Amounts owed to group undertakings are interest bearing, have no fixed date for repayment and are repayable on demand.

IMPERIAL TOBACCO HOLDINGS (2007) LIMITED

Notes to the Financial Statements

5. Net finance costs

(In £ thousand)	2019	2018
Interest payable to group undertakings	**249,548**	235,419

6. Tax on (loss)/profit

Factors affecting the tax charge for the year
The tax assessed for the year is lower (2018: lower) than the standard rate of corporation tax in the UK of 19.0 per cent (2018: 19.0 per cent). The differences are explained as follows:

(In £ thousand)	2019	2018
(Loss)/profit before taxation	**(249,548)**	1,764,581
(Loss)/profit before taxation multiplied by standard rate of corporation tax in the UK of 19.0 per cent (2018: 19.0 per cent).	**(47,414)**	335,270
Tax effects of:		
Group relief surrendered	**47,418**	7,904
UK-UK transfer pricing adjustment	**(4)**	36,826
Income not subject to tax	-	(380,000)
Total tax charged to the income statement	-	-

These are strong indications that Imperial Brands uses interest payments to lower its tax burden. However, we have not been able to identify the full chain of payments, as the company does not report in which countries or at which subsidiaries is has the outstanding loans. Therefore it is hard to conclude definitively whether or not these payments are artificial.

Group relief arising from internal interest payments

As mentioned above, IB reports large amounts of group relief. Imperial Tobacco Holdings (2007) ltd reports large losses and subsequently transfers large amounts of group relief, so that the accounting of corporation tax equals exactly 0. IB Finance plc and Imperial Tobacco ltd, which actually distributes products, were the main recipients of this group relief.

Royalties

Given that the other companies use royalty payments to avoid taxes, we would suspect Imperial Brands uses this device as well. However, this needs further investigation since the only record we found of royalty payments is at Altadis Luxembourg SA. The company reports about €6 million of royalty income per year, coming mostly from IT International Ltd, in the UK.

Tax disputes

We found three large tax ongoing tax-related legal procedures concerning Imperial Brands, involving tax claims totalling £672 million.

- The first involves a dispute with the French tax authorities about the internal sale of Altadis Distribution France (now known as Logista France) in October 2012. The tax authorities claim a higher share value. In December 2018 the French tax authorities issued their final assessment seeking the full amount of additional tax assessed (£240 million). In January 2019 the IB appealed against the assessment.

- The second dispute is with the Russian tax authorities about underpayment of excise tax between 2014-2016. The Russian tax authorities claims £132 million. IB appealed.

- The third involves EU State Aid investigations into the UK's Controlled Foreign Company legislation. In April 2019 the EU Commission concluded that the legislation up until December 2018 does partially represent State Aid (European Commission, 2019). The UK Government has appealed to the European Court. In the annual report of 2018 IB states that the potential amount of additional tax payable could be £300 million.

Japan Tobacco International

Subsidiary & dividend structure

JTI holds many subsidiaries and the internal structure is intricate.[9] In order to grasp the main hierarchy, we visualized it in the appendix.

It seems all dividends of the analysed subsidiaries flow through the Dutch subsidiary JTI International Group Holding BV. JT International Holding BV is the entryway to subsidiaries in other countries, including the British subsidiaries. Approximately €1-3 billion of dividends pass through JT International Holding BV every year.

Tax avoidance structures

Internal loans

The company participates in a cash pooling arrangement. Internal loans are used on a large scale to move interest around. JT International Holding BV (the Netherlands) plays an important role as the pool leader. It holds approximately $3 billion of loans to group companies. It holds about the same amount of short term borrowings from group and affiliated companies. Annually it receives over $100 million of interest income, and approximately ¼ of that amount flows out again to affiliated companies as interest expense.

Group relief

Some use of group relief is reported by the subsidiaries in the UK. Mainly Gallaher Overseas (Holdings) Limited, Gallaher Group Limited and JTI (UK) Management receive amounts of group relief, fluctuating around £2 million per year.

Remarkably, the net total amount of group relief received over the years equals £45.5 million. We have not identified the subsidiaries that surrendered the group relief to the recipients. Hardly any of the group relief received came from the analysed British subsidiaries. Further research is needed to paint the full picture.

[9] The arrangement of subsidiaries was subject to change over years. Furthermore, in some instances it was not completely clear which company was the direct parent of another. Figure 1 should thus be interpreted to give an impression of the structure, not to represent a completely accurate display of the concern relations.

Royalties

The direct subsidiary of JT, JT Europe Holding (later JT International Holding) reports $300 million royalties yearly to JT between 2010-2013 (only years available). As the overall structure of the subsidiary set up did not change, it seems likely that also in the subsequent years JTI made use of royalty payments. JT International Holding BV reports approximately $150 million yearly of 'charges to affiliated group companies' as general expenses between 2010-2016.

Tax disputes

The company reports many health related litigations. On tax-related litigations the parent company states the following in the annual reports: " The Company and some of its subsidiaries are also engaged in other legal proceedings such as commercial and tax disputes." However, they do not specify the relevant income tax claims.

For tax related litigations, subsidiaries refer to this annual report of the parent. We found three specifications of tax disputes:

- In 2018, JT (RMS) Ltd recognized a £12.8 million tax liability in response to an inquiry by HM Revenue & Customs. No further specifications are given.

- Another dispute was with the Turkish Ministry of Finance after an assessment of corporate tax in 2009. The amount of alleged tax due was assessed at $7 million. In 2013 the Court of First Instance ruled in favour of JTI and the corporate tax assessment was cancelled. The Tax authorities appealed. No further reporting about the case was found in the annual reports.

- Finally, in 2011 JTI Marketing & Sales ("JTI MS"), a Russian subsidiary of JTI, had a dispute with the Moscow City Tax Authorities regarding an assessment of VAT and profit taxes for the years 2005 to 2007 for a claim of $43 million. JTI MS brought suit to challenge the assessment. In October 2009, JTI MS lost at the Court of First Instance. In October 20 I 0, the Supreme Arbitration Court of Russia ruled in favour of JTI MS.

4. Base erosion and profit shifting: the regulation efforts

Our investigation of the four major tobacco companies is situated in a larger debate on tax avoidance by multinational companies. Policy debate over the past ten years has resulted in a specific action plan to mitigate the widespread use of aggressive tax planning. In our research we assessed how and whether the four tobacco companies changed their tax planning behaviour in response to these policy changes.

Base erosion and profit shifting ('BEPS') refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in international tax rules to avoid corporate taxes. In 2013, the OECD set up guidelines to address this, and in 2016, an inclusive framework was set up by the OECD and G20 to enable multilateral cooperation and political commitment to take action to reduce tax avoidance. The framework is explicitly called inclusive, as it aims to also involve non-OECD/G20 members, including the ones categorized as tax havens. At this moment, 135 countries are participating. The IMF, the UN, and the World Bank are observers of the inclusive framework (OECD, 2020).

Rules and regulations

The BEPS action plan contains 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment. Four action points are marked as minimum standards. These include:

- Action 5 (Countering Harmful Tax Practices), which addresses issues of transparency and substance
- Action 6 (Preventing Treaty Abuse)
- Action 13 (Country by Country reporting), which aims to tackle transfer pricing, and
- Action 14 (Dispute Resolution)

The 15 action points are guidelines or recommendations. The BEPS package has a mandate to provide guidance and support, monitoring, and reviewing the implementation of the minimum standards (OECD, 2019).

The European Commission (EC) launched an anti-tax avoidance package (ATAP) in order to implement several BEPS agreements. The ATAP comprises legally binding measures to present the most common methods used by companies to avoid paying taxes. For example, rules to limit interest deduction to no more than 30 percent of a company's income (European Commission, 2016).

Another component is the potential Controlled Foreign Company (CFC) rules, in which subsidiary income can be taxed under the home country's tax rate in cases in which the subsidiary is taxed at less than 40% of the home country's tax rate. The ATAP also includes a Commission recommendation on the implementation of measures against tax treaty abuse.

It is up to individual member states to implement and adhere to the ATAP rules. For instance, the Netherlands responded by updating substance requirements (see glossary). Moreover, it announced that it will start levying tax on interest and royalty payments from 2021, and dividend payments from 2024, in case the payments are directed to countries with a corporate tax rate lower than 9 percent (Bloomberg, 2020).

The mandate of the initial BEPS package ended in 2020, although an extension to 2025 was approved in Paris in 2019 by the OECD. It was concluded that the initial action points of BEPS had not resulted in reaching the envisioned goals. In particular Action 1, tax in the digital economy, needs further specification and substance. The renewed policy guidelines are organized into two separate pillars. Pillar 1 addresses taxing rights and nexus rules (a nexus is a relationship or connection between two or more entities. In fiscal law, it's a relationship between a taxing authority, such as a state, and a business (Murray, 2020). Pillar 2 outlines a global minimum tax and a tax on base-eroding payments. The update is sometimes referred to as BEPS 2.0 (Bloomberg, 2019).

Response to BEPS of the tobacco companies

We have not done a full assessment of whether the analysed tobacco companies operate in line with the BEPS (OECD) or ATAP (EU) regulations. We did evaluate whether we saw any major changes in their tax planning behaviour in response to changing regulations. Here we found indications that the introduction of BEPS did affect the tobacco companies, though maybe not in the way as intended by the OECD. The companies didn't start paying more corporate tax or stop engaging in aggressive tax planning. Revenues continued to grow steadily over these years, and the reported amount of corporate tax paid by the parent companies remained fairly stable. If this is the case for the overall subsidiary structures, this means these companies did not reduce base erosion and profit shifting.

A change we did identify at all companies, is that their annual reports contain significantly less information after 2015, particularly in the Netherlands. It might be that a consequence of stricter regulations in the Netherlands has led companies to become less transparent in their reporting.

After 2015, and maybe related to the BEPS guidelines, Imperial Brands made large changes in its financial structure. In 2018, Imperial Tobacco Limited, one of the top companies, reported a loss on impairment of investments, meaning they wrote down the value of their shareholdings in other IB companies, of €13.3 billion, while receiving dividends from Imperial Tobacco Holdings (1) ltd of €12.2 billion. Simultaneously, the company invested in subsidiaries in Spain, Ireland, France, Luxembourg, New Zealand, Australia, the Middle East and North Africa. The subsidiaries in Ireland stopped receiving large amounts of interest income after 2016. The implications of these financial movement for IBs tax planning are not yet clear to us and will require further investigation.[10]

For BAT, we suspect the sale of their shares in Landewyck Group (Luxembourg) in 2018 might be related to the BEPS regulation.

For Philip Morris International, we haven't yet seen any changes in its financial structures that might be related to the BEPS regulations.

JTI Ireland switched its immediate parent from Gallaher UK, to fall directly under the Dutch JT International Holding BV after 2015. Also, in 2014 subsidiaries on the Isle of Man were transferred from Gallaher Ltd to JT International Holding BV. The reasons behind these moves require further investigation.

[10] All this requires further investigation

Conclusions

Six European countries - Ireland, the UK, Switzerland, Luxembourg, the Netherlands and Belgium - facilitate the elaborate tax avoidance strategies of the Big Tobacco transnational Four. The Netherlands and the United Kingdom clearly have a key role in facilitating conduit subsidiaries. The role of Switzerland might be similarly important, but it is hard to confirm because of its financial secrecy.

Even though Imperial Brands and British American Tobacco are based and headquartered in the UK, and Japan Tobacco also makes extensive use of British subsidiaries, our database of annual reports (2010-2019) suggests that BAT pays little corporate tax in the UK and that IB managed to lower its UK tax burden by around £1.8 billion.

Gallaher ltd, a British subsidiary of JTI, does report substantial corporate tax payments in the UK. Further research is needed to verify whether the reported corporate tax, as copied into the database, is actually paid in the UK or overseas. The corporate taxes mentioned in the reports of British holding companies are often 'overseas taxes', paid by overseas subsidiaries. The exact amount of corporate tax that is being paid in the UK by British tobacco multinationals will be subject to our further investigations.

This extensive tax avoidance is facilitated through base erosion of revenues in the UK, and profit shifting to countries with lower corporate tax rates. The most common methods of base erosion are royalty payments and interest payments on internal loans. These payments are subsequently shifted as dividend, interest or royalty payments to countries that do not levy withholding taxes on them, such as the Netherlands and Luxembourg. From there, the money is channelled to tax havens with low to zero corporate tax rates. We have not been able to identify yet which tax havens the tobacco companies use as the ultimate destination for their profits.

All four Big Tobacco transnational companies make extensive use of these tax avoidance methods. Besides these, we also found other ways of base erosion. Philip Morris used the tolling system to decrease profit in the Netherlands. Group relief, or 'fiscal unity' structures are used by subsidiaries of Imperial Brands and Japan Tobacco. This implies that profits are written off against losses within the group in order to lower its taxable income. Finally, we found some large investment depreciations which may be related to base erosion. It will require further investigation to determine whether these depreciations have been valued at reasonable levels or are, in effect, part of aggressive tax planning.

It is difficult to determine whether the Big Tobacco's Transnational Four's tax avoidance strategies are in fact illegal. However, the amount of tax claims against them has increased in recent years. We identified tax disputes in at least eleven countries over the last 10 years. The claims vary between €45 million to €1.2 billion. So far, in the majority of cases, the courts' decisions have been in favour of the companies. Thirteen cases are still ongoing. The European Commission is carrying out an in-depth investigation into the activities of BAT in the UK and Belgium with respect to tax avoidance.

Increasingly, aggressive tax planning is regarded as (socially) undesirable. In 2016, the OECD has introduced international guidelines to reduce tax avoidance and evasion. At the time of writing about 120 countries, many of which are classified as 'tax havens', have agreed to participate in this BEPS (Base Erosion Profit Shifting) framework. However, we have not found any evidence that the BEPS guidelines have increased the corporate tax burden of the big four transnational tobacco companies after 2016. We did notice a restructuring of the subsidiary 'tree', most importantly at Imperial Brands. We also noticed that most companies provide significantly less information and financial data after 2016, particularly in the Netherlands. It could be that the companies will make more changes to their structures in the coming years, as more guidelines of the BEPS will be implemented on national levels. For instance, the Netherlands will start levying tax on interest, royalty payments from 2021 and dividend payments from 2024 to countries with a corporate tax rate lower than 9 percent.

Glossary/Definitions:

Aggressive tax planning: taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability. It's a term used to describe activities in the grey area between tax avoidance (which is technically legal) and tax evasion (which is clearly illegal).

ATAP: Anti-Tax Avoidance package: a directory for the adaptation and implementation of the BEPS by the European Union, with both guidelines for member states as well as proposals to address tax avoidance on a European level.

Base erosion: Base erosion is the use of tax planning tools and financial measures to lower the size of a company's taxable profits. It can be achieved by reducing profit (on paper), or increasing the reported costs. The latter we often see in high impairments on investments, high interest costs, high royalty payments or high costs of goods sold.

BEPS: Base Erosion and Profit Shifting. The acronym is used for the counter tax evasion programme of the OECD. The implementation of the BEPS regulations in the EU was done through the ATAP, and subsequently on individual member state level.

Cash pooling and intra-group lending: Under a cash pooling arrangement, entities within a corporate group transfer their surplus cash to a single bank account (the "master account") and, in return, may draw on the funds in that account to satisfy their own cash flow requirements from time to time. The master account is usually held by the parent company or by a "treasury company" established specifically for this purpose. All entities participating in the cash pooling arrangement are liable for any negative balance on the master account. Cashpools can be either physical, in the form of an intra-group loan, or 'notional', (also known as 'virtual'). The latter does not involve the physical transfer of funds, but the set-off of balances of different companies within the group, so that the bank charges interest on the group's net cash balance. Cash pooling arrangements need to comply with transfer pricing requirements, meaning that the internally accounted interests rates must be at reasonable market value.

Double Irish with Dutch Sandwich: an aggressive tax planning scheme, most notoriously used by Google and other large tech companies. The aim is to shift profit from, often the US, to a tax haven that does not levy corporation tax. In the process the company also wants to avoid any withholding tax payments. The scheme works as follows: a first company is established in Ireland. The intellectual property rights of the company are sold and parked at that Irish company. However, if this profit is offshored to a tax haven through royalty payments, Ireland would levy withholding tax. Therefore a Dutch company is established, as the Netherlands do not levy withholding tax on royalty payments within the EU. Subsequently a second Irish company is established that is headquartered in the tax haven. Ireland allows foreign owned subsidiaries to be taxed in that country. So the Dutch company pays the royalties to the second Irish company, held by a Bermudan owner. The profits will be taxed (or actually, not taxed) in the tax haven.

EU parent-subsidiary directive: "The Parent–Subsidiary Directive was designed to eliminate tax obstacles for profit distributions between parent companies and subsidiaries based in different Member States. The Directive therefore gives a tax exemption for dividends and other profit distributions paid by subsidiary companies to their parent companies. This eliminates the risk of double taxation i.e. the same income being taxed in the Member State of the subsidiary and Member State of the parent company" (European Commission, 2013).

Fiscal unity or group tax consolidation: some countries, such as the Netherlands and Luxembourg, allow a group of wholly or majority owned companies to be treated as a single entity for tax purposes. In other words, in a tax group the relevant companies (subsidiaries) are taxed as if it were only one taxpayer. This way the losses of one company in the group can be used to offset profits of another.

Group relief: The UK does not have a tax consolidation regime (does not allow fiscal unities). However, it does have a system of group relief, that permits the profits of one group company to be reduced by losses of another.

Group tax consolidation: see fiscal unity.

Intra-group lending: see cash pooling.

Notional interest deduction system: a fiscal construction in Belgium that allows part of equity income (dividends) to be deducted from the taxable income. Usually it is fiscally more advantageous to finance business activity through the use of debt (loan capital), as the interest paid is deductible from the taxable base, while with equity capital the dividends are taxable. This notional interest deduction allows a fictitious interest rate over equity financing to be deducted from the taxable income.

Patent Box (sometimes referred to as IP Box or Innovation Box): A tax regime that should function as an incentive for companies to perform research and development (R&D) activities in the country. It gives companies a reduced rate of tax on their profits from patents and similar intellectual property or it allows exempting the income that arises from intellectual property (royalties) for tax purposes.

Profit shifting: Profit shifting involves the shifting of taxable profits from high-tax jurisdictions to low-tax jurisdictions. This is achieved by making payments to subsidiaries in foreign countries. These payments are often in the form of dividends, interest, and royalty payments.

Substance requirements: legal requirements to ensure a subsidiary is not an empty shell or conduit company. These requirements differ per country, and are historically known to be non-existent in tax havens. One of the action points coming from the OECD's BEPS programme is the multilateral implementation and thickening of substance requirements. Substance requirements may order a minimum of the number of directors to live in the country of registration, that decision-making and bookkeeping happens in the country of registration, qualification of the staff and a bank account by a bank in the country of registration.

Tax ruling: an agreement between a company and the Tax Authority of a jurisdiction on how their tax will be calculated. It is a written interpretation of tax laws as applicable to a company, issued by tax authorities. A tax ruling binds tax authorities to comply with the tax arrangements set out in the ruling. A tax ruling is thus not an agreement about the tax rate. It is a way to reduce uncertainty about the tax position of a company. For example, a tax ruling can be used to confirm a company's transfer pricing arrangements, or which prices the tax authority deems reasonable. Another example of a tax ruling is the clarification of the tax treatment of R&D or intellectual property. Some countries, such as the Netherlands and Luxembourg, are known for having a favourable tax ruling climate.

Tolling system: system used by Philip Morris in the Netherlands, until the closing of most of the Dutch production activities in 2014. On paper, the Dutch entity PM Holland BV converted raw materials into cigarettes as a licensee for the Swiss entity PM International Management SA. This Swiss entity kept ownership of the raw materials as well as the finished product. PM Holland received a 'tolling fee' for the production activities, consisting of the fixed and variable costs incurred in production. This way, any profits made on the Dutch activities were actually kept in Switzerland, potentially avoiding corporate taxes in the Netherlands.

Transfer pricing: the price at which subsidiaries of the same companies transact with each other. Examples of this are the purchase of intermediate goods, trade of supplies, or the use of labour and services. Transfer prices are used when individual entities of a larger multi-entity firm are treated and measured as separately run entities. In principle these transactions need to be made at 'arm's length', i.e. at a reasonable market value. Even if these separately run entities are consolidated on a financial reporting basis, each entity (subsidiary) must report transfer pricing separately for tax purposes. Obviously it is difficult for an external party to evaluate the value of intra-group transactions. Therefore companies use transfer pricing as a profit shifting method. In some cases, the transfer of goods and services from one country to another can also enable a company to avoid tariffs on goods and services exchanged internationally.

Ultimate beneficial owner (UBO): a legal term which refers to the natural person or persons who ultimately own or control a legal entity or arrangement, such as a company, a trust, or a foundation (which are legal entities, not natural persons).

Withholding tax: an income tax to be paid by the payer or issuer of the income rather than by the recipient of the income. The tax is thus withheld or deducted from the income due to the recipient. Many jurisdictions, but not all, require withholding tax on payments of interest or dividends. Also there can be additional withholding tax obligations if the recipient of the income is a resident in a different country. In that case withholding tax may also apply to royalties, rent or the sale of real estate.

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Acknowledgements

This report is the result of a co-operation of The Investigative Desk, based in Amsterdam (the Netherlands) and the Tobacco Control Research Group of the University of Bath (United Kingdom).

TheID is a co-operative of highly specialised investigative journalists. It is structured as an independent foundation and is a registered Public Benefit Organisation.

The research was financed jointly by TheID and the University of Bath. TheID acquired additional funding from the EU Journalism Fund (Money Trail program).

TheID conducted the research and wrote the report. Dr. Rob Branston, who is a member of the Tobacco Control Research Group, provided useful additional information and offered important comments on the draft.

Competing interests disclaimer

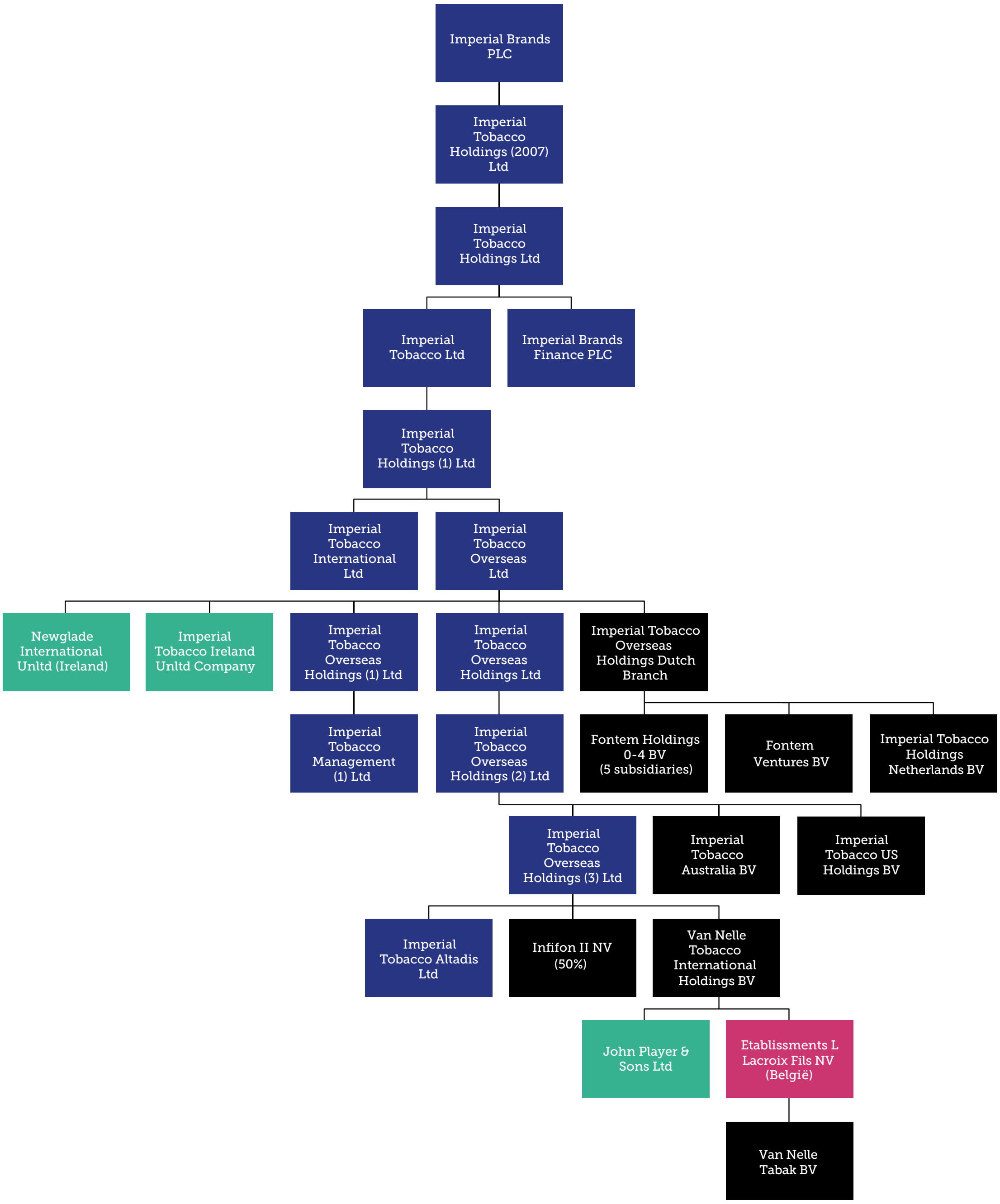
Dr. J. Robert Branston owns 10 shares in Imperial Brands for research purposes. The shares were a gift from a public health campaigner and are not held for financial gain or benefit. All dividends received are donated to tobacco/health related charities, and proceeds from any future share sale or takeover will be similarly donated.

The Tobacco Control Research Group (TCRG) of the University of Bath is the research partner in STOP, the global tobacco industry watchdog. Only academics from the TCRG had input into the research for the report or its contents. STOP is funded by Bloomberg Philanthropies, (www.bloomberg.org). The funder had no role in planning, writing or reviewing this report.

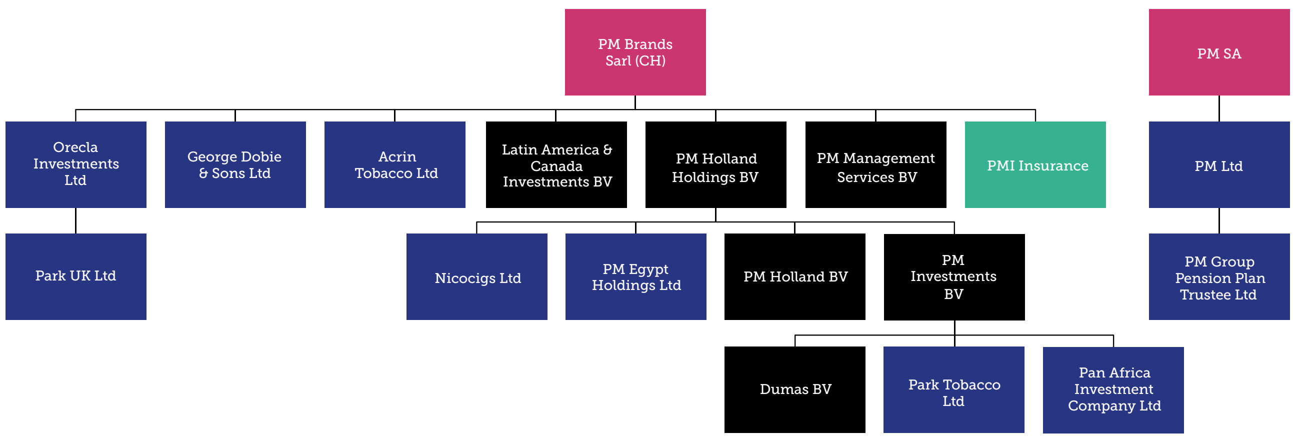
Appendix

Main company structures of the Big 4

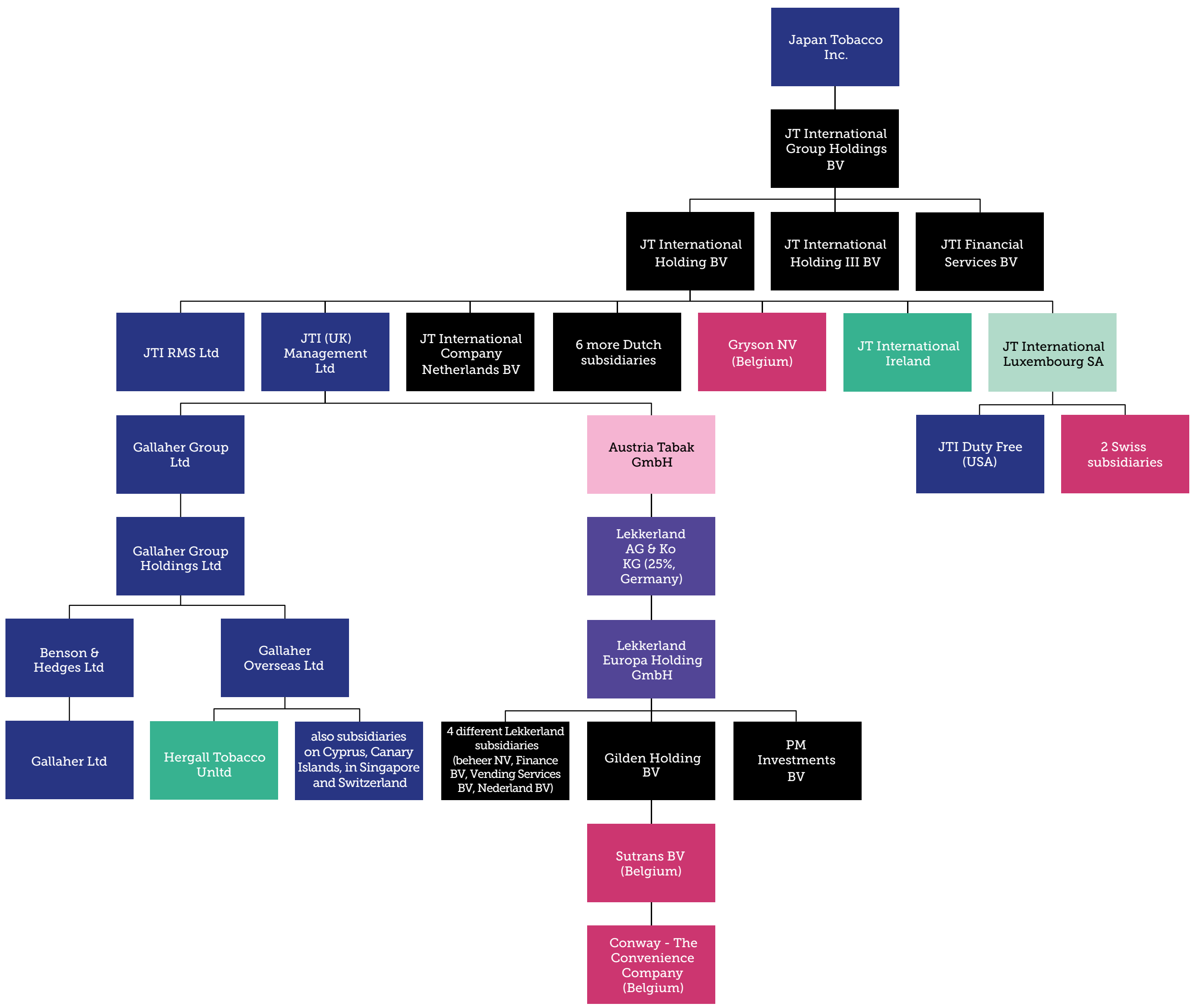
Imperial Brands



Philip Morris International



Japan Tobacco International



British American Tobacco

THE INVESTIGATIVE DESK

The Investigative Desk is a cooperative of highly specialised investigative journalists
Office: Gaasterlandstraat 5, 1079 RH Amsterdam, the Netherlands
+31 6 54674124 / www.investigativedesk.com / desk@investigativedesk.com