FIXING THE CRACKS IN TAX: A PLAN OF ACTION

Joint recommendations to the G20 and OECD for tackling base erosion and profit shifting

In this policy brief, 34 organisations that collaborate to achieve tax justice provide recommendations to the G20 and the Organisation for Economic Co-operation and Development (OECD) on the Action Plan presented by the OECD, in July 2013, to tackle base erosion and profit shifting (BEPS).

Introduction

In February 2013, the OECD published a report, *Addressing Base Erosion and Profit Shifting.*[1] The report was the OECD's initial response to the mandate it received in 2012 from the G20 leaders, who showed deep concern about the problem of tax-base erosion and profit shifting by transnational corporations (TNCs).[2] The OECD's report clearly stated the need for revisiting the fundamentals of the international tax system.

In July 2013, the OECD launched a new BEPS report, *Action Plan on Base Erosion and Profit Shifting.*[3] The report identifies 15 actions to tackle BEPS.[4] It also assigns each action to concrete working parties and task forces,[5] and sets deadlines for the delivery of the expected outputs. The BEPS Action Plan provides the opportunity for all non-OECD G20 countries to participate in the BEPS project on an equal footing. The Action Plan will be discussed in September, when the heads of state of the G20 countries meet in St Petersburg.

The OECD's BEPS Action Plan is a welcome and long overdue step forward. The OECD – and also the G20 and the G8 – has clearly acknowledged that base erosion is a serious problem that threatens the integrity of the Corporate Income Tax (CIT), and damages governments, individual taxpayers and some businesses. The BEPS Action Plan provides a unique opportunity to foster fundamental changes to prevent double non-taxation of income effectively,[6] as well as to prevent cases of no or low taxation associated with TNCs' practices that artificially segregate taxable income from the activities that generate it.

If successful, the project will help governments tackle tax avoidance and evasion by TNCs. However, strong political courage will be required to define, implement and enforce reforms to counter base erosion effectively. During the next two years of discussions – and during the implementation phase that will follow – governments will need to resist the pressure that will come from those benefiting from the current system, and implement the agreed measures as soon as possible. Civil society will continue to monitor the process closely and mobilise public opinion to ensure that governments live up to their promises and deliver effective solutions.

This policy briefing explains why base erosion and profit shifting is a threat for developed and, especially, developing countries, and it provides a number of recommendations to the G20 and the OECD. In particular, we call upon the G20 and the OECD to:

1. Take effective steps to ensure that developing countries can participate in the BEPS process on an equal footing, and assist them in implementing measures to stem their losses from international tax avoidance that deprives governments of badly needed revenues.

2. Undertake – jointly with other organisations, policy makers from developing and developed countries, and independent experts – a rigorous study of the merits, risks and feasibility of more fundamental alternatives to the current international tax system, such as unitary taxation, with special emphasis on the likely impact of these alternatives on developing countries.

3. Implement additional measures to tackle financial and corporate secrecy, including the requirement for TNCs to provide public combined and country-by-country reports, the establishment of comprehensive multilateral automatic exchange of tax information, and the public disclosure of the beneficial owners of companies, foundations and trusts.

How base erosion and profit shifting undermine development efforts

Erosion of a country's tax base takes place when TNCs reduce their tax burden by avoiding the payment of taxes where income is generated. Base erosion constitutes a serious risk to the tax revenues needed by governments to finance public services, but also to tax sovereignty and tax fairness. **Put simply, base erosion perpetuates poverty and contributes to increasing inequality.**

Base erosion occurs because the international system for the taxation of TNCs is no longer fit for purpose. International tax rules, drawn up 80 years ago, have not kept pace with the changing business environment.

In addition, inter-state tax competition to attract foreign direct investment (FDI) has resulted in an inconsistent and broken international tax system: one full of loopholes that provide TNCs with plenty of opportunities to avoid paying their fair share of tax.

A significant source of base erosion is the ability of TNCs to shift profits from where businesses perform their activities – and, therefore, generate their income – to low- and zero-tax jurisdictions where, very often, little or no substantial business activities are undertaken. Table 1 (below) identifies some of the most common types of transactions arranged by TNCs in order to shift profits to low- and zero-tax jurisdictions.

The tax avoidance devices used by TNCs to reduce the taxes they pay help to sustain the tax haven and offshore secrecy system – a system that is also used to facilitate illicit capital flight and laundering the proceeds of crime, including tax evasion, and the proceeds of corruption.

Base erosion causes damage in at least four main ways:

1. It deprives governments of badly needed revenues to combat poverty and foster human development.
2. It damages public respect for tax laws and governmental institutions, thus undermining tax compliance and weakening the relationship between the state and its citizens.
3. When TNCs are able to avoid paying their fair share of tax, other citizens must bear a greater share of the burden; this dynamic contributes to increasing inequality.
4. Local corporations that operate only in domestic markets are disadvantaged in competing with TNCs that have the ability to shift their profits across borders to avoid or reduce tax.

Base erosion is especially harmful for developing countries, where tax revenues as a percentage of GDP are around half of that in OECD countries.[7] Low levels of tax revenues limit states' ability to fulfil the most fundamental human rights of the population, such as the right to food, health and education.

Table 1

TNCs seeking to minimise their tax bills often use cross-border payments to shift profits to low- and zero-tax jurisdictions. These payments can include:

- **royalties**
- **interests**
- **payments for goods purchased for resale**
- **fees for technical and other services**
- **payments for supplies and equipment.**

The transactions that allow TNCs to shift profits to low- and zero-tax jurisdictions produce an unfair allocation of income. These transactions may not always be illegal, but the efforts made by companies and their advisors to exploit legal loopholes are often devious.

Even when potentially illegal transactions are identified, the enforcement of tax laws can lead to a long and expensive process, especially for developing countries. In fact, the complexity and ineffectiveness of the current rules for pricing transactions between related parties, based on the arm's length principle, has become part of the problem. Weak transparency in corporate reporting makes enforcement difficult as well.

In recent research, Christian Aid found that TNCs operating in India with links to tax havens could have paid as much as 30 per cent less in tax than TNCs with no such links.[8] Some of the commonly used tax avoidance strategies have also been revealed by ActionAid's reports, *Calling Time: Why SABMiller should stop dodging taxes in Africa*[9] and *Sweet Nothings*.[10]

In developing countries, Corporate Income Tax (CIT) constitutes around 18 per cent of tax receipts, compared to 12.6 per cent in high-income countries,[11] and compared to around 10 per cent in the UK and 7 per cent in the United States.[12] There are different reasons why CIT is relatively more relevant in developing countries, often related to the existence of narrow tax bases. Each year, developing countries lose US$160bn because of tax dodging.[13]

Recommendations to strengthen the BEPS project

1. The OECD and the G20 should invite developing countries to participate in the BEPS project on an equal footing.

The fact that non-OECD G20 emerging economies such as Brazil, South Africa, Indonesia and India are able to take part in the BEPS project is a positive step, but the absence of smaller developing countries at the negotiating table must be redressed by the OECD and the leaders of the G20, as a matter of urgency.

The OECD has stated that developing countries will contribute to the BEPS project through the Task Force on Tax and Development, as well as the global fora on Tax Treaties, on Transfer Pricing, on VAT, and on Transparency and Exchange of Information for Tax Purposes. According to the OECD, the participation of the United Nations Committee of Experts on International Cooperation in Tax Matters (the UN tax committee), as an observer in the OECD's Committee of Fiscal Affairs (CFA), is also expected to facilitate the participation of developing countries.

However, since the start of the BEPS project none of these mechanisms have been effective in enabling smaller developing countries to contribute. The participation of developing countries, who are usually net capital importers, is required to ensure that both their interests and their specific context and features are taken into account. It cannot be assumed – as it is often the case – that the interests of countries such as Brazil, India, South Africa or Indonesia are synonymous with those of smaller non-G20 countries.

The experience of previous decades shows that excluding developing countries from decision making can lead to the emergence of competing international standards and rules, and the replacement of the much-needed consensus by unilateral measures that will only increase uncertainty together with the risks of double taxation and non-taxation of income.

The OECD and the G20 should invite representatives of developing countries to take part on an equal footing – and for the duration of the BEPS project – in the different established working groups. These include the taskforce on the digital economy, the aggressive tax planning working party, and the group of experts for the development of a new multilateral instrument.

2. The OECD and the G20 should make efforts to strengthen the UN tax committee.

As stated above, the OECD has claimed that the involvement of the UN tax committee in the BEPS project will facilitate the contribution of developing countries. But, in practice, the UN tax committee is under-resourced to play that role effectively.

Many OECD countries have consistently rejected calls for the increased resourcing of the UN tax committee, claiming – misleadingly – that a better-resourced UN tax committee would duplicate the functions of the OECD. The fact that the OECD is now calling for increased cooperation with the UN tax committee shows how the two bodies can work together, but only if the committee is resourced to do so.

In order to strengthen the tax committee – and thus the BEPS project – the OECD and the G20 should commit resources to ensure the committee and its sub-groups are adequately enabled to perform the analytical and cooperation work entailed. The UN tax committee should have the capacity to contribute actively to the discussion, and not just agree to sell the solutions identified by the OECD without shaping them.

The UN tax committee needs to establish formal mechanisms to ensure that views from developing countries are truly represented and voiced, especially those of smaller developing countries. However, it needs to be noted that the committee's role in the project cannot exclude the possibility of developing countries participating in the established working groups on an equal footing, as stated above.

3. The G20 should urge the OECD to follow its own recommendations regarding the duty to analyse the impact of potential tax policies on developing countries.

In 2011, the OECD, along with the UN, IMF and World Bank, recommended in a joint report[14] to the G20 development working group that consideration of changes to tax policies should include the undertaking of spill-over analysis[15] of the impact of these potential policies on third countries, especially developing countries.

The need for conducting spill-over analysis was also considered in the 2013 G8 tax declaration, where G8 leaders stated, firstly, that developing countries need to be able to secure the benefits of international tax reform and, secondly, that developed countries have a duty to help developing countries collect their fair share of tax and to ensure that their domestic rules do not allow or encourage TNCs to reduce overall taxes paid by artificially shifting profits.[16]

The G20 should urge the OECD to follow its own recommendation and explicitly state that such a spill-over analysis is an indispensable requirement for the success of the project.

4. The G20 and the OECD, along with other bodies such as the UN tax committee and the IMF, should work with governments in developed and developing countries, as well as with independent tax experts, to explore alternatives to the arm's length principle.

As the G8 recently acknowledged, there continue to be significant problems in both developed and developing countries when it comes to enforcing the OECD's arm's length principle, which treats the different entities that form TNCs as independent.

The existing problems are not limited to transactions involving intangibles, capital or risks, as the BEPS Action Plan seems to suggest. Obtaining adequate 'comparables' for tangible products, or avoiding TNCs' arbitrary application of the different pricing methods, will continue to be a serious challenge, especially for developing countries.

The current problems related to enforcing the arm's length principle undermine tax revenues, cause conflict, increase uncertainty for taxpayers and consume enormous resources for both businesses and tax administrations. Despite the progress made in the OECD's Action Plan, many tax justice activists remain concerned that the OECD plan is attempting to salvage an international corporate taxation system that is fundamentally flawed.

In its report, the OECD acknowledges that measures beyond the arm's length principle may be required to deal with some of the problems identified. While this is a step in the right direction, the BEPS Action Plan fails to establish a process to rigorously assess alternatives to the arm's length principle, such as unitary taxation with formulary apportionment.

We therefore urge the OECD and the G20 to cooperate with other bodies, such as the UN tax committee and IMF, to establish an open and inclusive process to assess the merits, risks and technical feasibility of alternatives to the arm's length principle. Policy makers from developed and developing countries, as well as independent tax experts from the global North and South, should be invited to participate. Special emphasis should be put on assessing the likely impact of any alternative method on the tax revenues of developing countries.

5. Governments in the G20 must take additional measures to tackle financial and corporate secrecy.

If policy makers and political leaders have the political courage required to resist the pressure that lobbies with vested interests will exert, the BEPS Action Plan will deliver significant progress. However, the BEPS project itself will not be sufficient per se to tackle tax dodging. The G20 should agree to adopt the following additional measures:

(i) Automatic information exchange.
The G20 must endorse automatic information exchange as the new global standard, and support the implementation of a new multilateral platform for its implementation. The G20 must ensure that developing countries are included in this process from the outset.

(ii) Public disclosure of beneficial owners of companies, foundations and trusts.
Automatic information exchange will be less effective without public disclosure of the beneficial owners of companies, foundations and trusts. Tax evaders, corrupt officials and criminals must not be able to hide their identity and assets behind shell entities. All G20 countries must commit to establishing public registers of the beneficial owners of companies, foundations and trusts.

(iii) Enhanced transparency of TNCs' tax practices through worldwide combined tax reports and public country-by-country reporting.
The current requirements on corporations for the disclosure of their tax practices are weak and support their tax dodging strategies. Corporations should be required to submit a worldwide combined report to the tax authorities of each country in which they operate, including consolidated accounts, as well as a public country-by-country breakdown of their employees, physical assets, sales, profits, and taxes due and paid.

6. Governments in the G20 must promote a shift from tax competition to global and regional tax cooperation.

In their efforts to attract increasing FDI, countries from all around the world have implemented tax policies that have had negative effects on the welfare of populations, with most of the benefits accruing to TNCs and their tax avoidance advisors.

Some of the policies that countries have adopted unilaterally in previous decades to attract FDI have significantly helped TNCs to avoid paying their fair share of taxes. They include the progressive reduction of corporate income tax rates, the establishment of inappropriate tax treaties, the use of ineffective tax incentives, or even the granting of secrecy provisions and lax legal enforcement. These policies have not only enabled tax avoidance and evasion, but also corruption and other strategies of illicit capital flight.

Governments in the G20 must promote a shift from unsustainable and damaging tax competition to tax cooperation.

Endnotes

1 OECD, *Addressing Base Erosion and Profit Shifting,* Paris, February 2013, www.oecd.org/tax/beps.htm

2 See http://g20mexico.org/images/stories/temp/G20_Leaders_Declaration_2012.pdf

3 OECD, *Action Plan on Base Erosion and Profit Shifting,* Paris, July 2013, www.oecd.org/ctp/BEPSActionPlan.pdf. The new OECD report claims that (i) new international standards must be designed to ensure the coherence of corporate income taxation at the international level; (ii) realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards; (iii) the actions implemented to counter BEPS cannot succeed without further transparency, not without certainty and predictability for business.

4 These 15 actions are, as follows: address the tax challenges of the digital economy; neutralise the effects of hybrid mismatch arrangements; strengthen Controlled Foreign Corporation (CFC) rules; limit base erosion via interest deductions and other financial payments; counter harmful tax practices more effectively, taking into account transparency and substance; prevent treaty abuse; prevent the artificial avoidance of Permanent Establishment status; assure that transfer pricing outcomes are in line with value creation for intangibles, risks and capitals, and other high-risk transactions; establish methodologies to collect and analyse data on BEPS and the actions to address it; require taxpayers to disclose their aggressive tax planning arrangements; re-examine transfer pricing documentation; make dispute resolution mechanisms more effective; develop a multilateral instrument.

5 In addition to the existing OECD working parties, the BEPS Action Plan involves the establishment of (i) an Aggressive Tax Planning working party (resulting from the upgrade of the current Aggressive Tax Planning Steering Group); (ii) a task force on the digital economy; (iii) an informal group of experts to advise on the development of a new multilateral instrument to implement the agreed measures to counter base erosion (action 15 of the plan).

6 Double non-taxation of income takes place when income earned by a corporation or individual is not taxed in any jurisdiction.

7 House of Commons International Development Committee, *Tax in Developing Countries: Increasing Resources for Development,* Fourth Report of Session 2012-13, 16 July 2012, p5.

8 Alex Prats and Petr Jansky, *Multinational Corporations and the Profit-shifting Lure of Tax Havens,* Christian Aid Occasional Paper 9, www.christianaid.org.uk/images/ca-op-9-multinational-corporations-tax-havens-march-2013.pdf

9 See www.actionaid.org.uk/tax-justice/calling-time-the-research

10 See www.actionaid.org/publications/sweet-nothings

11 Calculations from data in the USAID ‘Collecting Taxes’ database: all data from 2010 (latest year available).

12 US Internal Revenue Service, *Data Book 2009,* table 1, p3.

13 See Andrew Hogg et al, *Death and Taxes: The true toll of tax dodging,* Christian Aid, 2008, www.christianaid.org.uk/images/deathandtaxes.pdf

14 OECD, *Supporting the Development of More Effective Tax systems,* 2011, www.oecd.org/ctp/48993634.pdf

15 In their report, the UN, OECD, IMF and World Bank asked developed economies to ‘undertake “spill-over” analyses of the impact of any significant changes in our own tax systems on those of developing countries, and support efforts to develop tools to counter tax evasion and avoidance in developing countries’.

16 ‘G8 Lough Erne Declaration’, issued from the G8 summit, June 2013, www.gov.uk/government/uploads/system/uploads/attachment_data/file/207543/180613_LOUGH_ERNE_DECLARATION.pdf

Supporting organisations

ActionAid International

Christian Aid (UK)

Global Alliance for Tax Justice

Oxfam

Tax Justice Network

IBIS (Denmark)

Alliance Sud, the Swiss Alliance of Development Organisations (Switzerland)

Global Policy Forum (USA/Germany)

SOMO Centre for Research on Multinational Corporations (The Netherlands)

Kairos Europe (Belgium)

Micah Challenge International

Tax Research UK

New Rules for Global Finance (US)

Finnwatch (Finland)

War on Want (UK)

Canadians for Tax Fairness (Canada)

CCFD – Terre Solidaire (France)

World Economy, Ecology and Development – WEED (Germany)

Sherpa (France)

Asia Initiatives (US)

Halifax Initiative (Canada)

Berne Declaration (Switzerland)

Uniting Church in Australia, Synod of Victoria and Tasmania (Australia)

Centre for Budget and Governance Accountability (India)

Fiscal Justice Network of Latin America and Caribbean

Latin American Network on Debt, Development and Rights – LATINDADD

Debt and Development Coalition Ireland

Instituto Centroamericano de Estudios Fiscales – ICEFI (Guatemala)

Centro Bonó de República Dominicana (Dominican Republic)

Fundaciòn Nacional Para el Desarrollo – FUNDE (El Salvador)

Centre national de coopération au développement – CNCD-11.11.11 (Belgium)

Red por la Justicia Tributaria en Colombia

Jubilee USA

Tax Justice Network – Israel