NO MORE SHIFTY BUSINESS

A response to the OECD's *Base Erosion and Profit Shifting* report on tax published in February 2013

In February 2013, the Organisation for Economic Co-operation and Development (OECD) published its report, *Addressing Base Erosion and Profit Shifting*.[1] The report is the OECD's initial response to the mandate it received in 2012 from some political leaders in rich countries, which clearly showed deep concern about the problem of tax-base erosion and profit shifting by multinational corporations (MNCs).

The 2012 G20 leaders' summit in Mexico, on 18-19 June, explicitly referred to 'the need to prevent base erosion and profit shifting' in its final declaration.[2] This message was reiterated at the G20 finance ministers' meeting of 5-6 November 2012, the final communiqué of which stated: 'We welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting.'[3]

In the same month, the UK's Chancellor of the Exchequer George Osborne and Germany's Minister of Finance Wolfgang Schäuble issued a joint statement,[4] also backed by France's Economy and Finance Minister Pierre Moscovici, calling for coordinated action to strengthen international tax standards and for states to back the OECD's efforts to identify loopholes in tax laws.

US President Barack Obama voiced such concerns in 2012 in The President's Framework for Business Tax Reform, which said: 'Empirical evidence suggests that income-shifting behaviour by multinational corporations is a significant concern that should be addressed by tax reform.'[5]

We are delighted to hear the political leaders of some of the world's most powerful countries calling for a reform of the current international tax system. However, the problems that political leaders are now mentioning – problems that enable MNCs to avoid paying their fair share of tax and undermine efforts to tackle poverty and inequality – are not new. For decades, developing countries have been the main victims of an unfair and ineffective tax system, as the signatories of this document have long maintained. Only when the damaging consequences have been felt in the richest economies have G20 and OECD leaders called for solutions.

We believe the OECD is right: the current international tax system is outdated and broken. The fundamentals need to be revisited.

In its report, the OECD makes a comprehensive analysis of the underlying causes and main consequences of the problem of base erosion and profit shifting (BEPS). The following ideas expressed in this report deserve to be highlighted. For an organisation committed to the cautious language of international diplomacy, these are dramatic statements:

- Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike.
- The artificial profit shifting strategies adopted by MNCs to minimise their tax bills are a fundamental cause of base erosion.
- The international tax rules first drawn up 80 years ago have not kept pace with the changing business environment. The current rules are not fit for purpose.
- The current international tax system allows and indeed encourages MNCs to eliminate or significantly reduce taxation by use of artificial devices.
- Abusive tax avoidance by MNCs provides them with an unintended competitive advantage in relation to corporations that operate at a domestic level. What is at stake is the integrity of corporate income tax. Abusive tax avoidance raises serious issues of compliance and fairness.
- There is an increased segregation between the location where actual business activities take place and the location where profits are reported for tax purposes. In other words, MNCs are not paying their taxes in the countries where they obtain their profits.
- If other taxpayers, including ordinary citizens, think that MNCs can legally avoid paying their fair share of tax, it will undermine compliance by all taxpayers.
- Unilateral action will not solve the problem. A holistic and comprehensive approach is necessary to address the issue. Any solution adopted must take into account the consequences on other countries.

In addition to the points above, there are two very important statements in the OECD's BEPS report.

First, the current international tax system no longer reflects how MNCs operate. Current international tax rules assume that the different entities that constitute an MNC act independently from one another. However, the recent scandals involving Amazon, Ikea, Google, Starbucks, Glencore – the list goes on – have clearly revealed that this is not the case. Today, the different entities that form a multinational group operate as a whole and follow an overall business strategy. Yet, the current rules used to tax MNCs ignore this reality, as the OECD rightly states.

Secondly, the OECD says that incremental approaches may not respond to several of the challenges governments face today. This is why the OECD has called on governments to think outside the box and identify new approaches to the taxation of MNCs. What is needed is a revision of the fundamentals of the existing standards.

We believe the OECD is right: the current international tax system is out-of-date and broken. As a result, MNCs exploit the existing loopholes to their own advantage, often advised by lawyers and consultants who make significant profits from the tax avoidance industry they have helped to develop. Developing countries have been suffering the consequences of an unfair tax system for too long. New international rules are needed, and a fair distribution of the global tax base should be the main goal. However, for this to happen, rules for the taxation of MNCs can no longer be based on fiction; they need to reflect how businesses operate in today's globalised world. As the OECD asserts, the fundamentals of the current tax system need to be revisited.

Towards a fairer and more transparent tax system

When it comes to the taxation of MNCs, current international tax rules treat the different branches and subsidiaries that form the multinational group as independent companies. This notion is at the heart of the OECD's Arm's Length Principle. The reality is that the current tax rules are based on a false assumption. Not surprisingly, these rules have in fact contributed to the problem for which urgent solutions are now desperately being sought.

If MNCs were treated as just one single entity, rather than as the sum of independent companies, they would not be able to benefit from creating fictitious entities in tax havens as a strategy to avoid or evade taxes. Nor could they exploit to their advantage – and at everyone else's expense – the many existing loopholes in bilateral tax treaties.

In 2011, a leaked audit report on the Mopani copper mine in Zambia, owned by Swiss metals dealer Glencore, alleged that the mine had sold copper to a Swiss subsidiary of Glencore at below-market prices, while exponentially increasing the operational costs of the Zambian mine from 2005-07. Inflated costs, combined with undervalued copper exports, allegedly enabled the company to report overall losses, and pay little or no corporation taxes in Zambia, with an estimated Zambian tax loss of some £76m in one year alone.[6]

In February 2013, ActionAid's investigation of the Zambian sugar operations run by global food company Associated British Foods (ABF) found that profits of over 20 per cent are being booked in Ireland by an Irish subsidiary, with millions of dollars of management fees paid annually from ABF's Zambian sugar company. However, the Irish subsidiary has no real presence or activities in Ireland and management services are provided from South Africa.[7]

According to recent research by Christian Aid on 1,500 MNCs operating in India, MNCs with links to tax havens paid 30.3 per cent less in taxes in 2010 than MNCs with no such links. The debt ratio of MNCs with connections to tax havens was found to be 11.4 per cent higher. India is home to one quarter of the world's undernourished population.[8]

Aggressive tax avoidance by MNCs hinders development.

Naturally, the current rules present some scope for improvements that would lead to a better tax system: these include applying restrictions on the deductibility of payments to tax havens and avoiding the offshoring of intellectual property. Political measures could also be adopted: for instance, applying sanctions to noncooperative jurisdictions or to the professional enablers of abusive tax avoidance and evasion. These and other measures could certainly allow developing countries to increase their tax revenues, but they would not address the underlying causes of the problem identified.

As the OECD states, the anti-avoidance measures adopted by many countries in previous decades – such as general anti-avoidance rules (GAAR), Controlled Foreign Company rules (CFC) or thin-capitalisation rules – have become too complex, costly and often ineffective. Consequently, the solution cannot simply involve the strengthening of anti-avoidance rules. Instead, many of the existing problems can be tackled by adapting the tax rules to the current business reality.

The OECD's analysis in its BEPS report is an urgent call to design a new international tax system that:

- **redresses the unjust distribution of the global tax base. Each country should be able to tax a fair share of the profits earned by MNCs operating in their territory**
- **treats MNCs as what they really are: complex structures that are bound together by centralised management, functional integration and economies of scale**
- **makes MNCs pay their taxes where their economic activities and investment are actually located, rather than in jurisdictions where the MNC's presence is fictitious and explained by immoral tax avoidance strategies.**

Treating MNCs as just one entity would not only be more realistic, but would also lead to a more transparent and easy-to-administer system.

In order for MNCs to be taxed according to their real nature, two measures should be introduced:

- MNCs should be required to submit a worldwide combined report, including consolidated accounts, to the tax authorities of each country in which they operate.
- MNCs should be required to provide a country-by-country breakdown of their employees, physical assets, sales, profits and taxes actually due and paid.

These two measures could be the basis of a tax system that would consider the total profits made by a MNC, rather than the profits made by any of its parts. It would then allocate these profits to the different countries in which the MNC conducts its real business, according to transparent criteria. Each country would be free to decide what tax rates to apply to their corresponding tax base.

These measures should be complemented by others in order to foster financial transparency, such as the public disclosure of the beneficial owner of companies, foundations and trusts, and the adoption of automatic information exchange as the new global standard.

We need evolution, not revolution

We are not asking for a revolution, but for an evolution of the current international tax system. We are asking for a determined and focused gradual change.

Requiring MNCs to provide a global combined report could be done within the international rules that are currently in place. In fact, the United Nations' Manual on Transfer Pricing already recommends that tax authorities require MNCs to provide worldwide consolidated accounts to facilitate the effective implementation of transfer pricing audits. Consolidated accounts are also necessary to apply the 'profit-split' method, which is already allowed within the current OECD guidelines. Under this method, the total profits of a MNC are allocated to different jurisdictions according to so-called 'allocation keys' – clear and concrete criteria defined on a case-by-case basis by the parties concerned.

Prominent MNCs that have expressed their desire to pay the correct tax in each country could also be encouraged to agree to Advance Pricing Agreements (APAs), based on such a profit apportionment. APAs are already being used by many countries to help companies avoid disputes over transfer pricing, and they can be agreed bilaterally and multilaterally between companies and countries.

Governments could build on these experiences to gradually evolve – based on practical learning – towards a tax system that is coherent with how businesses now operate and allocates profits fairly to countries.

As mentioned above, the current OECD Arm's Length Principle considers the different entities that form a multinational corporation as independent. If MNCs are to be taxed in a way that recognises what they really are – one single entity – then the current standard needs to be discarded as a feasible option. In fact, many countries such as Brazil and China, and even the European Union – through the Corporate Common Consolidated Tax Base (CCCTB) – are already implementing or exploring substantial modifications or alternatives to the Arm's Length Principle.

A gradual move towards a unitary approach for the taxation of MNCs would also require revising some of the rules established in the OECD and UN Model Conventions, with special attention to articles 5, 7 and 9. Rapid change to the network of over 3,000 bilateral treaties should be delivered through a multilateral mechanism that fosters inter-state cooperation. Indeed, a significant update of the OECD's work on harmful tax competition, which dates back to 1998, is urgently needed.

Is unitary taxation a magic bullet?

A unitary approach to the taxation of MNCs would not be problem-free. Indeed, there are no perfect systems, and taxpayers will always try to find their way round any new rules that threaten their profits. This is precisely why calculated evolution, rather than revolution, is required.

A unitary approach to the taxation of MNCs should ultimately lead to a new international tax system in which every country, especially developing countries, is able to tax a fair share of the profits earned by MNCs operating in their territory. To make this possible, a number of areas would require further research. Some of the more salient challenges involve establishing what constitutes a unitary business, defining the MNC's global tax base, identifying formulas that split profits fairly among the different jurisdictions in which the company operates and agreeing how to adapt the system to the nature of different sectors, such as the extractive industries.

However, even if it presents challenges that would need to be overcome through global cooperation, unitary taxation of MNCs would reflect how they operate today and would immediately put an end to many of the strategies they adopt in a bid to avoid and evade taxes.

The practice of artificially shifting profits to subsidiaries based in low-tax jurisdictions where there is no real economic activity would become pointless.

As for the risks and challenges identified, we believe that the UN Tax Committee and the OECD should work together, with as many other agencies as required, to develop a comprehensive research agenda that helps identify the challenges and find feasible solutions.

The OECD states that the current tax system is broken and out of date. It also affirms that aggressive tax avoidance by MNCs raises issues of fairness and compliance.

Therefore, alternatives to replace the current rules for the taxation of MNCs must urgently be explored.

A unitary approach for the taxation of MNCs would better reflect how businesses operate in today's globalised world. It would also make the aggressive strategies adopted by MNCs to avoid paying their fair share of tax pointless, especially artificial profit-shifting to tax havens.

But unitary taxation could also bring new risks and challenges. Serious research needs to be undertaken.

Any reform of the current rules must lead to a fairer tax system, one in which developing countries will obtain their fair share of tax.

This is why any process that does not allow developing countries to participate on an equal footing is not acceptable.

A final word: developing countries cannot be excluded from this process

The process suggested by the OECD in its BEPS report is a call to find global solutions to global problems. As stated at the beginning of this paper, developing countries have suffered by far the most negative effects of ineffective and unfair international tax rules. Consequently, any process that aims to revisit the fundamentals of the current tax system cannot exclude developing countries from deliberations and decision making.

At present, evidence strongly suggests that there will be no space in the process for developing countries to defend their interests. Once more, there is a risk that rich economies will devise solutions that play only to their advantage. We find this unacceptable.

We call on the OECD and the G20 to ensure that the path followed to find solutions to the problem of base erosion and profit shifting will include and take into account the voices of political leaders and civil society in developing countries. The UN Tax Committee should play a key role in this very relevant process. What is required is tax justice for everyone, and not just for OECD and G20 countries.

This is the final word in this paper, but it could as easily have been the starting point.

Endnotes

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

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

3 http://g20mexico.org/index.php/es/comunicados-de-prensa/537-final-communique

4 www.hm-treasury.gov.uk/chx_statement_051112.htm

5 www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf

6 www.actionaid.org.uk/103027/glencore_tax_dodging_in_zambia.html

7 ActionAid, *Sweet Nothings: The human cost of a British sugar giant avoiding taxes in southern Africa*, February 2013, www.actionaid.org.uk/doc_lib/sweet_nothings.pdf

8 *Multinational corporations and the profit-shifting lure of tax havens*, Christian Aid Occasional Paper 9, by Alex Prats and Petr Jansky. www.christian-aid-org

Supporting organisations

Action for Economic Reforms (Philippines)

African Forum and Network on Debt and Development (AFRODAD) (Africa)

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

Attac Norway

Australian Education Union (Australia)

Berne Declaration (Switzerland)

Canadian Council for International Co-operation (CCIC) (Canada)

Canadians for Tax Fairness (Canada)

Catholic Bishops' Organisation for Development Cooperation – Misereor (Germany)

CCFD – Terre Solidaire (France)

Centre for Budget and Governance Accountability (India)

Centre for Social Concern (CFSC) (Malawi)

Centre National de Coopération au Développement, CNCD –11.11.11 (Belgium)

Centro Internacional para Investigaciones en Derechos Humanos (CIIDH) (Guatemala)

Ciase (Colombia)

Christian Aid (UK)

Decidamos (Paraguay)

Economic Justice Network (South Africa)

European Network on Debt and Development (Eurodad) (Europe)

Finnwatch (Finland)

Forum Solidaridad – Peru

Global Policy Forum Europe (Germany)

Halifax Initiative (Canada)

IBIS (Denmark)

Inter Pares (Canada)

International Alliance of Catholic Development Organisations (CIDSE) (International)

Jubilee – Australia

Kairos (Europe)

Lantidadd (America Latina)

Malawi Economic Justice Network (MEJN) (Malawi)

Methodist Tax Justice Network

National Taxpayers Association (NTA) (Kenya)

Netzwerk Steuergerechtigkeit (Germany)

New Rules (USA)

Norwegian Church Aid (Norway)

Perkumpulan Prakarsa (Indonesia)

Plateforme Paradis Fiscaux et Judiciaire (France)

Red Jubileo – Peru

Red Nicaragüense de Comercio Comunitario (RENICC) (Nicaragua)

Sherpa (France)

SJ Around the Bay (Australia)

Social Justice (Ivory Coast)

Southern and Eastern African Trade Information and Negotiations Institute (SEATINI) (Africa)

Secours Catholique – Caritas (France)

Spire (Norway)

Tax Justice Network

Tax Justice Network – Africa

Tax Justice Network – Australia

Tax Justice Network – Europe

Tax Justice Network – Germany

Tax Justice Network – Israel

Tax Justice Network – Netherlands

Tax Justice Network – Norway

Tax Justice Network – USA

Taxpayers Against Poverty (UK)

Union Aid Abroad – APHEDA (Australia)

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

Weltwirtschaft, Ökologie & Entwicklung (WEED) (Germany)