Re: C20 meeting September 2015

Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project

Increasing public revenue through progressive taxation is crucial to finance essential public goods, services and investments. Fair taxation can help in fighting inequality, realising human rights, and ensuring the implementation of the Sustainable Development Goals (SDGs). An important step to achieving such aims is to put an end to tax avoidance aided by the use of tax havens by multinational enterprises (MNEs), and so help to raise corporate tax revenues in developing countries and developed countries alike.

In 2013, the G20 world leaders mandated the Base Erosion and Profit Shifting (BEPS) project to produce reforms of international tax rules that would ensure that multinational enterprises could be taxed 'where economic activities take place and where value is created', and that developing countries should also be able to benefit.

Two years later, the Global Alliance for Tax Justice fears that neither of these objectives will be reached.

Although the Organisation for Economic Co-operation and Development (OECD) has extended participation in this work to all G20 countries, and more recently some other developing countries and regional tax administration networks, it cannot substitute for a truly inclusive global tax body. While important developing country members of the G20, such as India, have demanded such an institution, at the Third International Conference on Financing for Development (FFD3) held in Ethiopia in July 2015, key OECD countries vetoed proposals from developing countries to create a global tax body. Given the current unsuitable institutional framework, it is hardly surprising that the BEPS project of the OECD/G20 will be at best partially effective, and will pose major problems of implementation - especially for developing countries.

Reform is long overdue not only to the institutional framework but also to the existing global taxation rules, which are now over 80 years old. The fundamental flaw of these rules is that they have been interpreted to require taxation of MNEs as if their various constituent entities are independent of each other and dealing 'at arm's length'. This creates a perverse incentive to create complex and fragmented corporate structures, locating affiliates in convenient jurisdictions to minimise tax; MNEs now consist of often hundreds of such entities.

The G20 mandate implied a new approach, to treat the corporate group of a MNE as a single firm, and attribute its tax base according to its real activities in each country. The OECD has refused to make this explicit, and has continued to emphasise the arm's length principle, while attempting to counteract its harmful consequences. Consequently, the BEPS outputs fail to provide a coherent and comprehensive approach, and offer instead a patch-up approach. Moreover, several of the OECD proposals (notably weak Controlled Foreign Corporation (CFC) rules, interest deductibility and innovation box schemes)

have been greatly weakened by the insistence of some powerful OECD member states, aiming to preserve their preferred tax breaks for business, while others have stubbornly defended the dysfunctional arm's length principle. The proposals will therefore make international tax rules even more complex, and will largely retain the scope for countries to offer tax breaks.

The major, though limited, advance is the proposal for Country by Country Reporting (Action 13), which could for the first time enable tax authorities to evaluate the MNE as a whole. However, the threshold of €750 million is too high, and the arrangements for filing and access are weak. All countries need access to these reports, yet access may be impeded under the proposed cumbersome scheme. The reports need to be published, as there is no convincing argument to suggest that they contain commercially confidential information. Publication would facilitate research and analysis of whether the international tax rules are meeting their stated objectives, and reassure the public.

The proposals on limiting interest deductions (Action 4) also began by treating MNEs as unitary, but have been weakened; a firm rule is needed that interest deductions should not be greater in aggregate than the corporate group's consolidated interest costs to third parties. Strong rules on Controlled Foreign Corporations could also do much to discourage MNEs from shifting income out of operating affiliates in source countries and parking them untaxed in countries with lower effective tax rates; however, the proposals are extremely weak and will encourage a continued race to the bottom in tax.

Concerning the regulation of harmful tax practices (Action 5), the OECD proposes an essentially self-policing system, substantially continuing the approach begun in 1998, which has had very limited effects. Already it can be seen that the attempt to apply the broad principles of 'nexus' and 'substance' to innovation boxes is only leading to a complicated system restricting some schemes while legitimising the concept as such. This has encouraged many countries to adopt their own regime and erode the corporate tax rate as a whole. Economically harmful tax incentives have proliferated in recent years, with many countries, especially developing countries sacrificing large percentages of GDP for no or limited return, while often undermining other countries' tax base. The draft for the Toolkit on tax incentives requested by the G20 Development Working Group contains only very weak technical recommendations.

As recommended by the OECD/World Bank/International Monetary Fund and United Nations to the G20 in 2011, G20 members should take the lead in showing best practices in transparency, monitoring, review, and accountability of tax incentives. A more binding framework is needed, with provisions for counter-measures. Furthermore, the general problem of tax competition needs to be addressed. The Global Alliance for Tax Justice reiterates our call made last year to G20 leaders that they should adopt a High Level Declaration against Tax Competition, with commitments from states to eliminate harmful tax practices and provide full transparency for all rulings.

The proposals on transfer pricing (Action 8-10) are particularly disappointing, as they still begin from the arm's length principle, allowing tax authorities to challenge intra-firm arrangements only by re-characterising transactions based on a 'facts and circumstances' analysis of functions, assets and risks, and searching for 'comparables' which both theory and practice show do not exist. Under this

approach, the attribution of the tax base of MNEs will remain largely a matter of negotiation between tax authorities and MNEs, with no clear criteria for allocation. This will require considerable skilled resources – challenging even for OECD tax authorities, let alone developing countries, increase compliance costs especially for SMEs, and leave wide scope for subjective and discretionary decisions. Work was begun on the profit split method, which could offer a way forward towards a unitary approach, but has been deferred for the next stage.

The reply to business fears of greater conflicts is to propose stronger dispute settlement, including a commitment by many OECD countries to mandatory binding arbitration (Action 14). Entrusting decisions involving often hundreds of millions of dollars to a secret and unaccountable procedure of third party adjudication is a totally inappropriate response to deal with problems caused by vague rules at the outset. Such a procedure is especially unsuitable for developing countries, which lack the resources to combat the complex arguments put forward by specialist professional firms on behalf of multinational enterprises. Furthermore, the system is biased since the revolving door between government tax departments and those professional firms creates a community of like-minded 'experts' committed to orthodox OECD approaches.

It is clear that much more work is needed to follow up and go beyond the BEPS project. This should include a reconsideration of the allocation of taxation rights between the countries of residence and source, an issue addressed in the BEPS project only in its action on the Digital Economy. In reality, this is part of a much wider challenge resulting from the dematerialisation of production, including the shift to services, and is of special concern to developing countries. Other priority issues for developing countries have also been identified by the G20 Development Working Group, but they are being addressed only by developing toolkits, generally adhering to orthodox approaches approved by the OECD.

What is needed instead is more imaginative alternative approaches, complementing and going beyond the work of the OECD. A global tax body, supported by the strengthened UN Tax Committee should be the forum to discuss and decide on these new approaches, building on South-South cooperation and the work of regional groups such as the African Tax Administration Forum (ATAF) and the Inter-American Center of Tax Administrations (CIAT).