A level playing field?
The need for non-G20 participation in the BEPS process

This paper is endorsed by the following organisations:

The Global Alliance for Tax Justice *(coalition of 81 civil society organisations in 37 countries)*
Tax Justice Network – Africa
Tax Justice Network - Europe
ActionAid International
CCFD-Terre Solidaire *(France)*
CEDETRABAJO *(Colombia)*
Centre national de coopération au développement,
Coordinadora Civil de Nicaragua *(alliance of 600 Nicaraguan civil society organisations)*
CNCD-11.11.11 *(Belgium)*
Christian Aid *(UK)*
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Halifax Initiative *(Canada)*
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Jubilee South - Asia/Pacific Movement on Debt and Development (JS-APMDD)
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Methodist Tax Justice Network
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Red por la Justicia Tributaria en Colombia *(Colombia)*
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Taxpayers Against Poverty *(UK)*
War on Want *(UK)*
World Economy, Ecology & Development - WEED *(Germany)*

SUMMARY

- The OECD's recognition that international tax rules have not kept pace with the realities of multinational business marks a major and welcome change from previous defences of the status quo.

- Its Base Erosion and Profit Shifting (BEPS) project has the potential to initiate the most significant international tax reforms for decades.

- Yet while the OECD has said that its "global comprehensive action plan" to tackle BEPS will be developed "in consultation with all stakeholders", the process is currently excluding all non-G20 countries, and thus most developing countries.

- Technically too, the BEPS process is currently focussed on aspects of BEPS related to developed economies' high-tech industries and digitalised consumer markets, while relegating the 'development' aspects of BEPS to capacity-building. This risks overlooking dysfunctions of the current international rules impacting on developing countries' tax bases, and prevalent in sectors central to developing economies, including agribusiness, extractives and telecoms.

- Corporate Income Tax (CIT) is even more important for developing countries' revenues, quantitatively and administratively, than for developed countries' revenues. A process that excludes the participation and interests of non-G20 economies will fail to safeguard the interests of those countries most reliant on CIT.

- Establishing an international tax settlement without the participation of the emerging economies of the future risks repeating the dynamics behind the current fragmentation of

international tax standards and practices.

- While the participation of the BRICS economies is critical, it cannot be assumed that their interests are synonymous with those of smaller non-G20 countries.

- The BEPS **process** must include non-G20 countries.

- Its **objectives** must include not only eliminating double non-taxation but also safeguarding developing and capital-importing countries' tax bases.

- It should not be confined to tackling tax challenges generated by intellectual property, or the 'digital economy'. It must tackle BEPS much more broadly, across the range of sectors central to all countries' economies.

RECOMMENDATIONS

Process

- The OECD and the Working Group chairs (France, Germany the UK and the USA) must ensure that non-G20 economies are able to participate fully in any re-write of the international tax rules within the BEPS process.

- Non-G20 countries' involvement in BEPS may include:
  - linking the three BEPS Working Groups to the work of the UN Tax Committee;
  - incorporating nominees from the Task Force on Tax and Development in the BEPS Working Groups and involving the Task Force in approval of the BEPS report – but only if the Task Force is able to undertake independent and representative decision-making.

- The BEPS process must take the time needed to involve non-G20 economies, including beyond the June reporting of the BEPS Working Groups.

Objectives

- The success of the BEPS project should be judged both against its success in reducing double non-taxation and aligning the tax base with economic substance, but also in safeguarding poorer countries' tax bases.

- BEPS reforms should *at least* safeguard capital-importing countries' tax bases (and prevent round-tripping via tax havens, which distorts FDI flows), including by permitting countries to enhance source taxation of cross-border income.

- While it is not the role of the BEPS process to address domestic tax rates, it *should* offer measures to reduce downward tax competition pressure driven by harmful and preferential tax regimes, particularly in tax havens.

- Solutions generated by the BEPS process should include measures applicable by all countries, including less well-resourced tax administrations.

A LEVEL PLAYING FIELD?

Corporate Income Tax is even more important for most developing countries than for developed countries

The "integrity of the corporate income tax"[i] is arguably of even more importance for the public finances of developing economies than developed ones, for well-rehearsed reasons that include:

1) **Greater significance of corporate tax in developing countries' tax bases:** CIT constitutes around 18% of tax receipts in low and lower-middle income countries, compared to 12.6% in high-income countries; [ii] and compared to around 10% in the UK and 7% in the USA, for example.[iii]

   Within the corporate tax base itself, multinationals are an even more significant source of CIT receipts in developing countries than in developed countries. This corresponds with narrower tax bases in general: large taxpayers across sub-Saharan African countries, for example, typically constitute less than 5% of taxpayers and typically contribute three-quarters of all tax revenues;[iv] in Kenya, just 0.01% of all taxpayers pay 50% of all VAT.[v]

   Necessary though efforts may be to broaden the tax base, they will need to avoid shifting the tax burden to poorer taxpayers, and multinational CIT payments will continue to be rightfully significant in the tax mix.

2) **Administrability:** Taxing business income at the level of the firm is administratively far more straightforward than taxing it at the level of personal income tax. For this reason alone, corporate profit tax is a hugely important tool for less well-resourced tax administrations.

3) **International equity:** taxing profits aims to ensure that business activities are taxed in the place where resources are extracted, labour utilised, goods manufactured. This is critical for developing economies. The most widely-discussed replacements for source-based or residence-based CIT - sales-based methods of taxing business income - would do significant damage to developing countries' tax bases in comparison to those of developed consumer economies.[vi]

BEPS is a developing country problem too

The BEPS report acknowledges that "*[m]ultinational enterprises (MNEs) are being accused of dodging taxes worldwide, and in particular in developing countries, where tax revenue is critical to foster long-term development*".[vii] There is indeed strong evidence that profit-shifting is occurring as much or more in non-OECD countries.[viii] Yet the BEPS report only addresses the issue of BEPS and development in a single box on the very last page of the report.[ix] This box proposes that for developing countries the BEPS problem is primarily one of *capacity* to apply the existing rules.

Much of the discussion and examples of base erosion and profit shifting given in the BEPS report has likewise depicted the problem as primarily generated by two features characteristic of developed economies' high-tech industries and digitalised consumer markets:

- **Intangibles:** the difficulty of pricing returns to highly individual intangible assets, and the ease with which such assets can be 'moved' into tax havens.
- **E-commerce:** challenges to countries' jurisdiction to tax presented by online economic activity whose 'real' location can easily be attributed to any low-tax jurisdiction.

It is true that developed economies' high-tech industries are dominated by knowledge-based assets; and that both online retail and digital business continue to be weighted towards Europe, the USA and emerging markets in East and South Asia.

But as ActionAid's examination of royalties paid by African and South Asian subsidiaries of brewing giant SABMiller has shown, profit-shifting via knowledge-based intangible assets relocated into tax havens may be equally prevalent in far more traditional industries, for instance with consumer brands or manufacturing processes.

Likewise 'hard-to-price' transactions are not limited to intangibles. They include intra-group services, for instance: as the new services article in the UN Model Treaty suggests, these are a particular issue for multinationals in developing economies, often recruiting in overseas expertise for management and other specialist functions, and often with management hubs located in tax havens.

Equally, tangible but company-specific intermediate products may be as difficult as to price as intangible goods and services, similarly transferred through tax haven procurement hubs, and as prevalent in the supply chains of breweries and agribusiness in the developing world as in pharmaceuticals, aerospace or other high-tech industries.

Tackling BEPS thus cannot be confined to the digital economy and high-tech manufacturing: it can and should also generate progress in those sectors central to developing economies - from extractives to agribusiness to telecommunications.

Finally, as economies develop, they will face some of the same corporate tax challenges as G20 economies. Future-proofing any new settlement of international corporate tax requires the participation of the emerging economies of the near future, not just those of the present.

Developing countries' interests may not be the same as those of emerging and developed economies

In tackling BEPS, it cannot be assumed that the interests of smaller non-G20 economies are always synonymous with those of developed economies.

There will certainly be areas of common interest. These include greater transparency of multinationals everywhere they operate, through requirements for combined and country-by-country reporting; and tackling instances of double non-taxation where both developed and developing economies' tax base may benefit. Perhaps perversely, as some developed countries' tax systems become increasingly territorial these 'win-win' instances may even increase, since much double non-taxation relies upon the non-taxation of foreign-source income, as seen in Figure 1 (although territorialising tax systems also increase incentives to shift foreign income to low-tax jurisdictions in the first place).[x]

But some measures to prevent base erosion and profit shifting will inevitably involve a redistribution of the tax base between countries with different kinds of economies and tax regimes. This is not to argue that such measures are not globally desirable - but that international consensus on such measures must incorporate the interests of all countries, and agree on tools which safeguard different economies' tax bases as much as possible.

- An obvious example is the option of defending against profit-shifting by allowing more source taxation of mobile income through withholding taxes where such income is taxed at very low rates at its destination (Figure 2). This would be of great revenue benefit for developing countries that are generally the net source rather than the destination of interest, royalties, dividends and management fees; and would also help prevent profit-shifting from developed countries into tax havens. Nonetheless developed countries levying low taxes on business income like management fees (such as Ireland), or on IP royalties (such as the UK under its new 'patent box' regime), may lose tax revenues on such income, after granting tax credits for the withholding taxes levied at source.

- Another example is the greater use of negotiated formulary methods, particularly those going beyond transactional methods to allocate the profits of related entities as a whole. Such methods may prevent abuse and bring better certainty to tax authorities and taxpayers alike. But they will likely require negotiations over which factors – sales, payroll, assets – should be given greater weight in profit allocation, especially as the growing use of bilateral or multilateral advance pricing agreements (APAs) require agreements between tax authorities (Figure 3). Countries' interests are often not synonymous in such negotiation, as recent US-India disputes over profit-splits have shown. Such negotiations may essentially entail governments bargaining over whether countries of production or consumption should be allocated greater taxable profits – bargaining in which the relative power of each party may mean that developing producer economies may not fare well, and may require rules or guidelines to protect poorer parties' tax bases.

FIGURE 1: A "win-win" BEPS solution – stopping double non-taxation through hybrid entity mismatch[xi]

If Country S (developing country) imposes a withholding tax on dividends to hybrid entities, country C (a developed country) does not lose tax revenue, since it has already exempted foreign intra-group dividends; nor does country T (a tax haven), since it has already exempted foreign income.[xii]

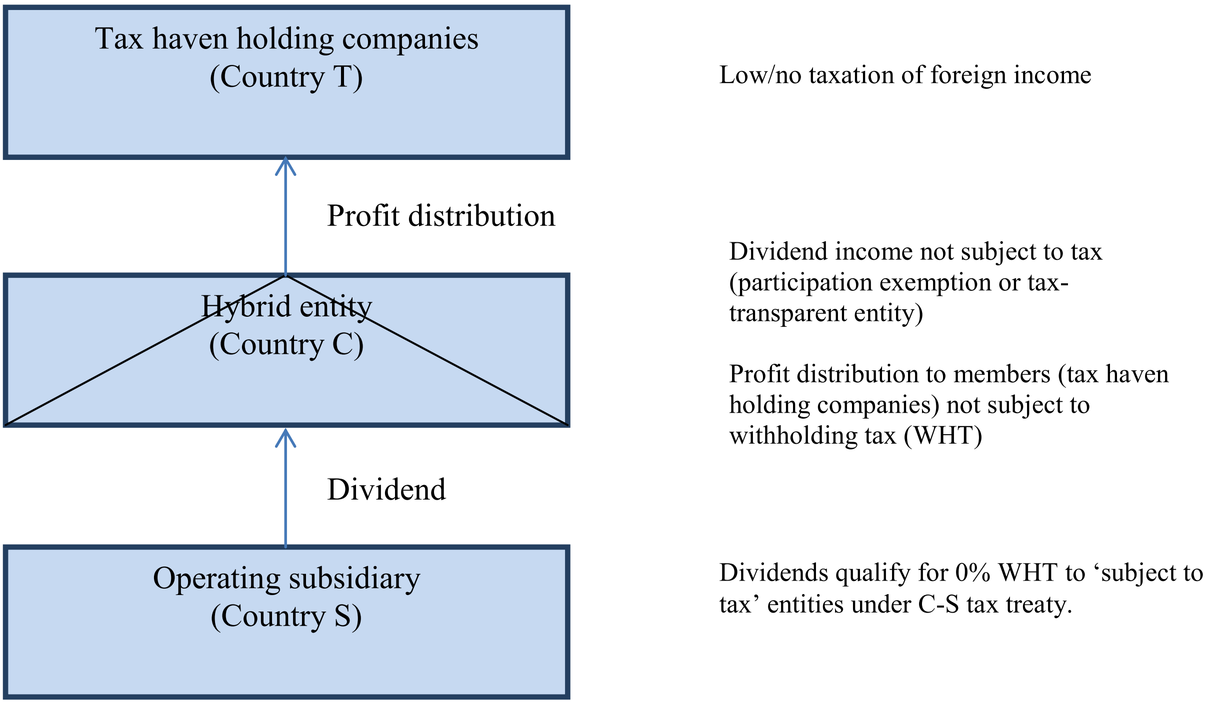


FIGURE 2: Redistribution of taxing rights - withholding taxes at source on cross-border income subject to low taxes in the country of destination

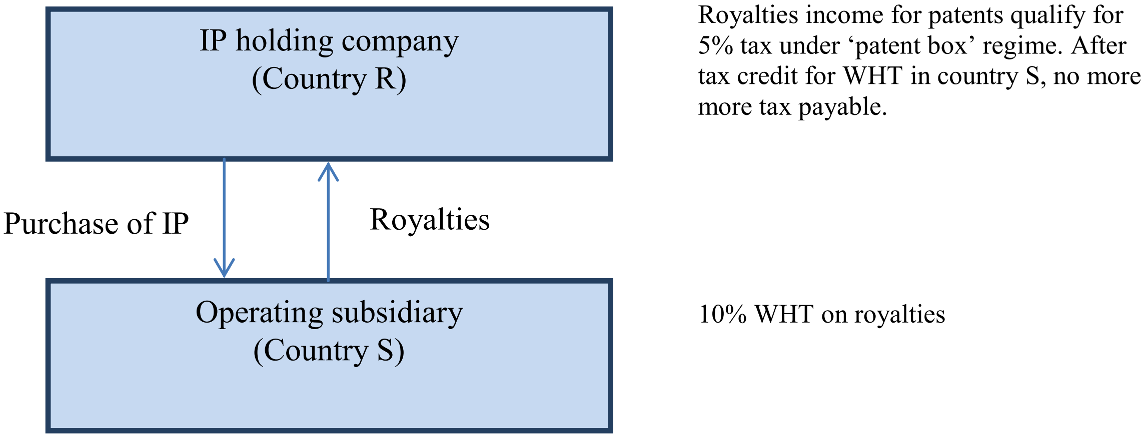
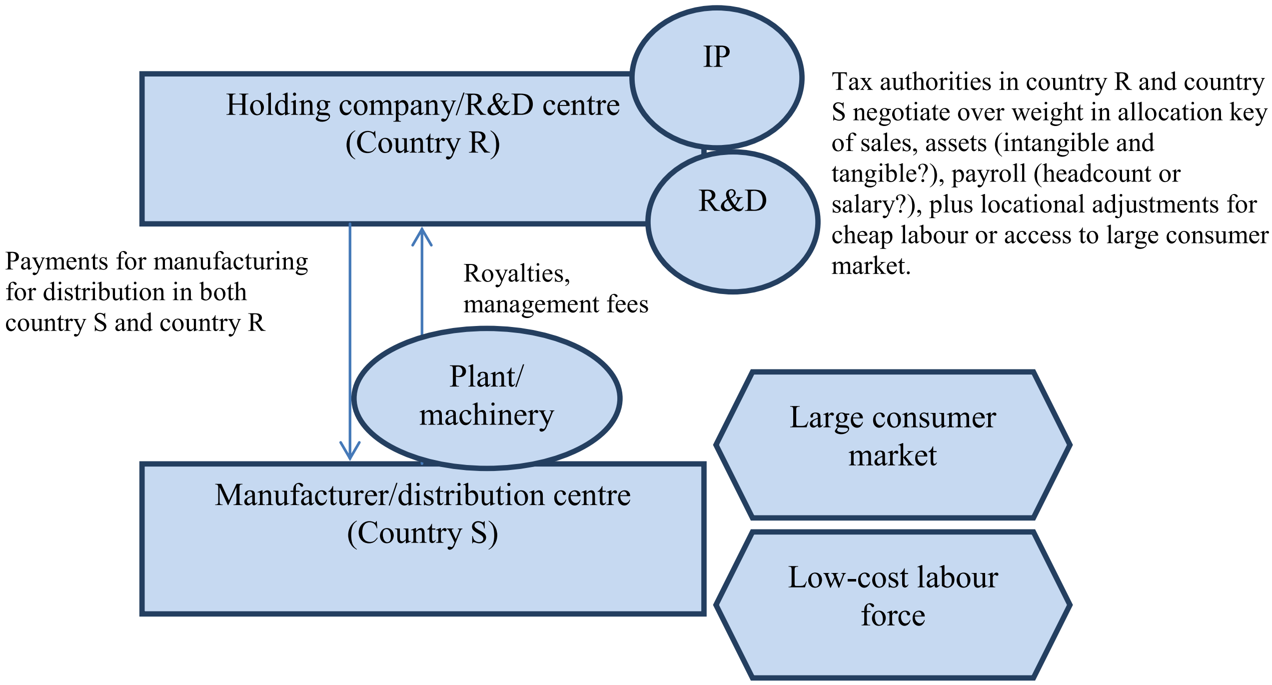


FIGURE 3: Negotiation of taxing rights – bilateral APA on formulary allocation of group profits



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Some may fear that consensus will be difficult to reach if very diverse economic interests, beyond the G-20, are represented around the table. But there is evidence that some developed countries are now prepared to countenance some shifts of the international distribution of taxing rights in their own enlightened self-interest: as suggested by the gradual movement towards taxation of services at source, a provision for which is included in some existing tax treaties between OECD and non-OECD economies, and is under discussion for the next draft of the UN model treaty; or by initiatives by countries like the Netherlands to revisit tax treaties with developing countries to promote those countries' domestic resource mobilisation (in an age of shrinking overseas aid budgets).

The OECD has been emphatic that BEPS is intended to deal with double non-taxation, not with wider questions of the international allocation of the corporate tax base. But in practice the two are inevitably linked, requiring all countries to be at the table.

The OECD has also argued that non-OECD countries are already being represented through the invitation of the BRICS economies (Brazil, Russia, India, China and South Africa) as observers to the OECD's Committee on Fiscal Affairs when it considers the findings of the BEPS Working Groups.[xiii] But the interests of the BRICS cannot be taken as synonymous with those of all developing countries. As growing capital exporters to smaller developing economies, they will increasingly play the role of 'residence country' in the kinds of scenarios outlined above.

Recommendations: a BEPS process that delivers for all countries

We believe the significance of CIT for non-G20 countries, and the inevitable impact of BEPS solutions on the distribution of the global CIT base, has implications for the BEPS project's **process** and **objectives**.

Process

1. OECD members – and particularly the BEPS Working Group chairs (France, Germany, the UK and the USA) must ensure that Non-G20 economies must be able to participate fully in any re-write of the international tax rules.

- Within the OECD BEPS process, this may include linking the three BEPS Working Groups to the work of the UN Tax Committee, which has wider developing-country participation and an explicit 'financing for development' mandate.

- Troublingly, the only OECD forum with wide developing country participation, the Task Force on Tax and Development, does not currently have BEPS on its formal agenda. [xiv] In any case, its previous meetings have not had a formal mechanism for making decisions or ratifying policies. The Task Force could be used to nominate non-G20 representatives from its 100+ members to the BEPS Working Groups, and to consider and ratify the BEPS document; but only if it has independent and meaningful democratic structure and processes.

2. The process must take the time needed to involve non-G20 economies, particularly beyond the June reporting of the BEPS Working Groups.

- One obvious reason for confining the BEPS process to OECD+BRICS economies is its breakneck speed, aiming to develop an Action Plan by June.

- This ambition to make progress with real change is commendable after many years of near-stasis in OECD tax rules. But proceeding rapidly without the participation of the emerging economies of the future risks repeating the dynamics behind the current incipient fragmentation of international tax standards and practices – a fragmentation which lies behind much of the current impetus towards reform.

Objectives

3. The success of the BEPS project should be judged both against its success in reducing double non-taxation and aligning the tax base with economic substance, but also in safeguarding poorer countries' tax bases.

- It is in all countries' interest to align the distribution of the corporate tax base more closely with economic activity.

- Within this objective, however, BEPS reforms should *at least* safeguard capital-importing countries' tax bases, including by permitting countries to enhance source taxation of cross-border income, even if they may not have the redistribution of the corporate tax base from global North to global South as their primary objective.

- While it is not the role of the BEPS process to address domestic tax rates, it *should* offer measures to reduce downward tax competition pressure driven by harmful and preferential tax regimes, particularly in tax havens.

- Solutions generated by the BEPS process should include measures applicable by all countries, including less well-resourced tax administrations.

NOTES

[i] OECD, *Addressing Base Erosion and Profit Shifting* (2013), p. 8

[ii] Calculations from data in USAID 'Collecting Taxes' database; all data from 2010 (the latest available year). Oil-rich countries (where oil and gas constitutes more than 25% of government revenues) generally derive an unusually high proportion of tax receipts from this sector, and so have been excluded from both developed- and developing-country datasets.

[iii] US Internal Revenue Service, *Data Book 2009,* Table 1 (http://www.irs.gov/pub/irs-soi/09databk.pdf); UK HMRC, *HMRC Tax and NIC Receipts* (21 March 2013), p. 3 (http://www.hmrc.gov.uk/statistics/receipts/info-analysis.pdf)

[iv] International Tax Dialogue, *Revenue Administration in Sub-Saharan Africa* (2010) (http://www.itdweb.org/documents/AfricaStudy.pdf).

[v] David Kloeden, *Revenue Administration Reforms in Anglophone Africa Since the Early 1990s* (IMF Working Paper WP/11/162), July 2011, Table 5 (http://www.imf.org/external/pubs/ft/wp/2011/wp11162.pd). N.B. Data from 2006.

[vi] See e.g. J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: the Mirrlees Review* (2010), Chapter 9 'Taxing Corporate Income'

[vii] OECD, *Addressing Base Erosion and Profit Shifting* (2013), p. 13

[viii] Christian Aid, *Multinational corporations and the profit-shifting lure of tax havens* (Occasional Paper No. 9), March 2013, http://www.christianaid.org.uk/Images/CA-OP-9-multinational-corporations-tax-havens-March-2013.pdf; C Fuest, and N Riedel, 'Tax Evasion and Tax Avoidance: The Role of International Profit Shifting', in P Reuter, *Draining Development? Controlling Flows of Illicit Funds from Developing Countries* (World Bank, 2012), https://openknowledge.worldbank.org/handle/10986/2242

[ix] OECD, *Addressing Base Erosion and Profit Shifting* (2013), p. 87, Box D.1

[x] See, for example, the use of hybrid corporate entities in jurisdictions like the Netherlands as holding companies for investments in developing countries: ActionAid Zambia/ActionAid UK, *Sweet Nothings: the human cost of a British sugar giant avoiding taxes in southern Africa* (February 2013), pp. 25-26.

[xi] For an example of this kind, see ActionAid Zambia/ActionAid UK, *Sweet Nothings: the human cost of a British sugar giant avoiding taxes in southern Africa* (February 2013), pp. 25-26.

[xii] This is obviously a simple example. Many hybrid entity mismatch situations will rely on tax consolidation to claim deductions of e.g. interest in both jurisdictions.

[xiii] Comments by Pascal St Amans at Oxford Centre for Business Taxation conference on 'Taxing Multinationals', 18 March 2013.

[xiv] The Co-Chairs' update on work of Task Force on Tax and Development (dated 7 February 2013) sets out details of forthcoming meetings focussing on capacity-building, transparency and transfer pricing, and then notes simply that "you will have noted that the OECD will very soon issue a report on Base Erosion and Profit Shifting (BEPS) and we look forward to discussing the implications for the developing world."