BASE EROSION AND PROFIT-SHIFTING (BEPS)

Contributions from civil society as a follow-up to 'No more shifty business'

In March 2013, 58 civil society organisations published the policy brief 'No more shifty business', in response to the OECD's report 'Addressing base erosion and profit-shifting'.

In our report, we stated that the OECD analysis is an urgent call to design a new international tax system that: (i) redresses the current unjust distribution of the global tax base, (ii) treats MNCs as what they really are: complex structures that are bound together by centralised management, functional integration and economies of scale, and (iii) 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 unacceptable tax avoidance strategies.

We also stated that the current exclusion of developing countries in the BEPS project is unacceptable and needs to be redressed as soon as possible.

This document contains the answers provided by civil society organisations to the following OECD's follow-up questions.

1. General questions.

1.1. Do NGOs agree with governments that base erosion and profit shifting is a significant problem? If so, is this contributing to the instability of the international tax system?

NGOs agree that base erosion and profit shifting is a very serious problem. As stated by the OECD and NGOs, evidence is overwhelming.

Base erosion and profit-shifting result from a deep structural flaw in the international tax system, and is indeed a major cause of the instability of that system. This flaw is the failure to treat multinational enterprises according to the economic reality of their activity. Instead, a principle has become gradually entrenched that they should be taxed as if they were operating as separate enterprises in each country dealing independently with each other. This fiction does not merely allow but encourages multinationals to organise their affairs by forming entities in suitable jurisdictions to reduce their overall effective tax rate.

The systematic tax avoidance which results from this basic structural flaw has many extremely harmful results. Governments and tax authorities are rightly concerned by the immediate revenue losses, but the ramifications go much wider:

- systematic tax avoidance by the largest and most powerful companies in the world undermines the legitimacy of taxation everywhere, as the February report on BEPS acknowledges;
- it gives the multinationals which exploit these avoidance opportunities very significant competitive advantages over national firms, resulting in inefficient allocation of investment and major distortions to economic activity;
- at the same time, it distorts the decisions of these firms themselves, resulting in some benefits to some countries but overall economic welfare losses;[1]
- it has particularly distorted the finance sector, greatly contributing to the creation of shadow banking, excessive leverage and other techniques, and hence the financialisation of economies, leading to the bubble which caused the financial crash of 2007-9, and the economic devastation that has followed;
- it sustains the international tax avoidance industry, resulting in enormously wasteful expenditures for both firms and governments;
- the techniques and facilities devised by the tax avoidance industry, using the `offshore' tax haven and secrecy system, are also used for all kinds of evasion, not only of taxes, including money-laundering for crime, corruption and terrorism;
- Base erosion and profit-shifting, and generally tax avoidance and evasion, seriously undermine efforts to tackle poverty and inequality, including official development aid.

It is therefore difficult to under-estimate the importance of dealing with this problem. Governments should therefore ensure that the international rules for the taxation of MNCs are thoroughly reformed to make them fit for the 21st century.

[1] C. Keuschnigg and M. P. Devereux (2012). "The arm's length principle and distortions to multinational firm organization." Journal of International Economics. http://dx.doi.org/10.1016/j.jinteco.2012.08.007.

1.2. What role can the OECD play in the BEPS project, and in restoring stability to the international tax system?

Despite its contested legitimacy, the OECD's Committee on Fiscal Affairs has become today the main custodian of the international tax system. Therefore, the OECD could help not only to restore some stability to the tax system, but as a result begin to remedy the much wider problems outlined above.

However, this is subject to a number of caveats:

- The OECD must ensure much wider accountability and transparency in its work, and become more open to divergent views and willing to reflect on the failings – and associated consequences - of the current system, for which it has been largely responsible.
- Whilst facilitating consultation, it must be discriminating and selective as regards the arguments and views which are taken into account. In the past, there has been too much deference to the avoidance industry, partly because it employs the specialists who are able to engage with the technical details often involved. This has resulted in a damaging process by which the international tax system has become the preserve of a relatively closed group committed to existing approaches. We hope that there is now a real willingness not only to think outside the box, but to adopt a new approach.
- Similarly, the creation of the Global Forum has given too much importance to the views and interests of the tax haven and secrecy jurisdictions. A more robust approach could and should be adopted to dealing with such countries, which have essentially become captives of the tax avoidance industry, especially as many of them are both politically and economically dependent on the leading OECD countries.
- More importantly, there must also be a new approach towards working with non-OECD countries. In the past, the OECD has used its participation in the UN Tax Committee to prevent that Committee from doing anything other than follow in the footsteps of the OECD, by limiting the scope of its work and obstructing any increase in its meagre resources. It has attempted to co-opt the larger and emerging economy countries by giving them a nominal role as Observers to the OECD. The OECD should provide the resources to enable the UN Tax Committee, whose membership is currently being renewed, to engage as a genuinely equal partner both in the BEPS project and the wider reconstruction of the international tax system which is needed.

- Developing countries cannot continue to be excluded from deliberation and decision-making processes. The current BEPS process aims to drive change at global level, but is biased towards the context and interests of OECD countries. In addition, it does not allow developing countries to participate on an equal footing. We find this unacceptable.

In our view, the BEPS project must provide a clear sense of direction towards the adoption of a new approach for the taxation of MNCs. It should involve moving away from the separate entity/arm's length principle, and towards treating multinationals as the integrated firms they are.

To date, there has been strong resistance to this, largely on the grounds that it would mean adopting an alternative system of `unitary taxation'. These fears are misplaced. Although `separate-entity' and `unitary' involve different approaches and perspectives, in practice there is considerable overlap. Many of the measures which have been introduced to adapt the `separate-entity' approach to the economic realities of multinationals already involve or imply treating them as unitary firms. It is therefore possible to build on existing experience and develop the details of a unitary approach gradually and pragmatically. What is now needed is a change of perspective, so that international tax rules as applied to multinationals encourage and support treating them as unitary firms.

Central to this approach should be the introduction of a requirement for multinationals to submit to the tax authorities of each country where they do business a Combined Report. This should include, for the current and previous 4 years (i) worldwide consolidated accounts, and (ii) both global data and a country-by-country breakdown of (a) the main measures of the real economic activity in each country (physical assets, employees and sales), and (b) the taxes actually paid. Without this information, no tax authority is in a position to form a realistic view of whether the profits and hence tax liabilities declared by the multinational in the country concerned are a fair reflection of its true activities. Indeed, the UN Manual on Transfer Pricing already recommends that states obtain such data for the purposes of transfer pricing audits.

The adoption of a unitary approach, together with the requirement for submission of a Combined Report, should provide the orientation for specific measures which could and should be adopted. As we have stressed, they do not necessarily require or entail adopting a fully-fledged system of unitary taxation with apportionment of profits by a formula fixed in advance. However, if there is a clear sense of direction towards a unitary approach, existing specific measures can be strengthened and new ones designed towards this new orientation.

At the same time, measures which further entrench the flawed separate entity perspective should be re-worked or phased out.

2. On ‘Countering Base Erosion’

2.1. How should economic substance be taken into account as a criterion for evaluating the tax treatment of transactions?

Economic substance should be the basis for evaluating the level of profit declared in each country, and the evaluation of the relationships and transactions between related parties should be geared to their effects on profit allocation.

What is important is not to adjust the terms of individual transactions by comparison with those between independent entities, which can never be truly comparable, but to evaluate whether the resulting profits are appropriate in view of the real economic activity and role of the respective parties.

2.2. How should governments deal with hybrid mismatches and arbitrage? How can governments ensure legal certainty while doing so? What kind of instrument is the most effective/appropriate?

The move away from the separate entity approach should mean that the characterisation of the legal status of an affiliate within a multinational becomes irrelevant. Instead, what should count is the real economic activity it performs. It is the excessive concern with the legal form of affiliates that leads to problems such as hybrid mismatches.

2.3. Would a general LOB clause (within tax treaties) be useful? Are there any restrictions that should be placed on the use of tax treaties which can be implemented without overkill/unbalanced negative effects on sound business practices?

A general LOB clause would help to reinforce a move towards evaluating profit apportionment on the basis of real economic factors, rather than spurious legal forms, so it would be a positive step. Reasonableness and economic substance tests should be used to determine when they should come into operation.

2.4. How would NGOs react to more uniformity in the way rules limiting interest deductibility operate? Would NGOs favour a more internationally coordinated approach on other deductible expenses, such as headquarters expenses?

A coordinated move towards ending interest deductibility would be a very constructive step for many reasons and would complement and support a move towards a unitary approach. Under such approach, intra-firm financial flows would in any case be disregarded.

As regards headquarters expenses, they are already frequently apportioned, and this would be systematised under a unitary approach.

2.5. How can MAP processes, including arbitration, be improved to address uncertainties or inconsistencies in how anti-avoidance/abuse rules are applied?

The most important improvement to MAP processes would be to publish their outcomes. This would greatly add to transparency, as well as promote uniformity and predictability, and hence the legitimacy of the international tax system.

The secrecy of both MAP processes and APAs greatly increases the power of frequent actors in these processes, i.e. the international tax and accounting firms, to the great detriment of the system as a whole. Developing countries are also often in a weak position to properly defend their interests.

Publication of both would be a great step towards a system which could provide, and more importantly be seen, to deliver a fair international allocation of tax.

3. On 'Jurisdiction to Tax'

3.1. What challenges exist in implementing the existing treaty standards?

The present treaty standards are based on a misleading distinction between residence and source countries, which suggests that profits should be apportioned between the country where the investor is resident and that where the investment is located. This concept reflects portfolio investment, and bears little relationship to the economic reality of multinationals.

A more realistic, appropriate and just apportionment of the global profits of their integrated operations should be based on evaluation and analysis of the true functions performed by each part of the firm and their real presence in each country. Residence in particular is easy to manipulate, so rights to tax business profits should be based on where actual activities take place. The location of the parent company of a group is important to the extent that it is the true headquarters and c can

perform other important functions such as R&D, but not merely because it is the holding company for shares.

3.2. Are there artificial arrangements that some businesses use to avoid jurisdiction to tax (e.g. PE status or withholding at source)?

Exploitation of residence and source rules are a central technique of international tax avoidance, as the recent scandals of Google and Amazon have shown.

One example is hedge funds, which claim to be resident and to source their trading income in low-tax jurisdictions, though their trading activity is directed from high-tax countries, especially London and New York.

A key advantage of a unitary approach is that it eliminates the complexities of residence and source rules.

3.3. For purposes of concepts such as PE, is the on-line sale of a digital product (e.g. e-books) different than the on-line sale of tangible products (e.g. printed books)? What are the key differences?

A key problem with the PE concept is that it is based on categorising a legal entity according to its physical presence in a country, rather than apportioning profits according to the physical presence in each country of the firm as a whole, regardless of the legal entities through which it chooses to operate.

Internet firms only show up most sharply the limitations of this approach. The digital economy is now ubiquitous, and it would not be feasible or desirable to devise separate rules for `digital economy firms' as a sector. Instead, international tax rules should be reformed to deal with the effects of the new phase of economic globalisation of which the digital economy is a key vector.

The PE concept should therefore be phased out, in favour of a wider definition of what constitutes doing business within a country.

3.4. Should governments coordinate their CFC legislation, and if so, what criteria are appropriate for income that is included in such regimes?

The strengthening of CFC legislation should be regarded as an interim measure. In one sense CFC rules are in line with a unitary approach, since they entail disregarding the separate legal form of the CFC. However, they can act to legitimise the separate entity, if it falls outside the CFC rules.

The latter has increasingly come to be the case, as CFC rules have been relaxed due both to tax competition and to economic globalisation, which makes it harder to define or apply them. Thus, the distinction between `active' and `passive' income has become increasingly difficult to maintain, as a greater number of economic activities have become easier to delocalise, for example sales, with the growth of ecommerce.

In the short term CFC rules could be strengthened though, eg by a concerted move towards treating income from all financial services and transactions as passive. States should end measures which have gravely weakened CFC rules, such as `tick the box', and the `patent box'.

4. On 'Transfer pricing'

4.1. Are there circumstances in which transfer pricing rules do not currently result in profit being aligned with the location of i) substance, or ii) "core value-driving activities" of a trade union? If so, what are the best ways to address that?

Current transfer pricing rules give too much importance to evaluating the terms of specific transactions by the criterion of comparable transactions between independent parties. It is widely known that, in practice, comparables are hard to find and they are rarely appropriate or true.

This was already recognised some 20 years ago when the OECD accepted profit apportionment, under the guise of `comparable profits' approaches. These allow the apportionment of aggregate profits, but are formally limited to the profits of aggregated transactions between particular related parties, although in practice a large number of related entities within a corporate group are likely to contribute to the generation of such profits, even if they are not directly transacting with all the others.

What is needed now is to build on and develop these profit apportionment methods, by (i) including in the aggregation all the profits generated by a unitary business, and (ii) identifying criteria for evaluating the substantive contributions and value-adding activities of the different parts of the business, to apportion the profits.

Two methods could be used for this, both accepted under the current profit split approach elaborated in the OECD Transfer Pricing Guidelines. One applies appropriate `allocation keys' directly to the aggregated profits. The other adopts a 2-stage process, first identifying the function performed by each part of the business and apportioning a level of profit appropriate to that function, and then apportioning the `residual' profits on the basis of allocation keys. A pragmatic approach towards developing appropriate profit apportionment methods could be adopted, on an industry or even case-by-case basis, building on these methods.

4.2. In analysing the risks of a global business, what are the relevant differences between branches and subsidiaries?

Neither risk nor the legal distinction between a branch and a subsidiary are appropriate criteria for apportioning the tax base of an integrated multinational company. By its nature, the multinational pools risks, as affiliates do not stand alone either financially or operationally. Allocating profits according to which entity is deemed to bear the risks therefore makes no sense.

A multinational also has a good deal of freedom in choosing between the branch and subsidiary form (though tax is not the only determinant in this choice). Certainly, in legal terms, a branch cannot bear risks separately from the rest of the company, while an affiliate can because it is formally a separate entity, but in the context of a corporate group the distinction is not a real one.

4.3. In what circumstances is it appropriate to disregard or re-characterise the form of a related party transaction for transfer pricing purposes?

As we have already stressed, the focus on the terms of specific transactions is inappropriate. Adjustment of the accounts of related entities under existing tax rules should shift towards ensuring that they reflect a level of profit consonant with the real economic activities of the whole firm within the country concerned.

4.4. Can NGOs identify best practices in the current transfer pricing practices by individual jurisdictions that can be used to address key transfer pricing issues (including the use of risk assessment tools to reduce the burden associated with transfer pricing documentation requirements)?

We have already stressed that the most appropriate methods are the profit apportionment methods accepted under current rules, which now need to be further developed and systematised.

This is particularly appropriate for developing countries, for which it would be a waste of resources to either develop or apply the expertise to attempt to use approaches based on comparables, which have largely proved a failure elsewhere.

The challenge is to identify appropriate profit allocation keys which adequately reflect the true economic activities within each country. Adoption of this approach would simplify documentation requirements for firms, as well as other elements of current transfer pricing rules which are time-consuming and burdensome for both firms and tax administrations.

List of signatories

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' Organization 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)
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 Alliance for Tax Justice
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)

Latindadd (America Latina)

Malawi Economic Justice Network (MEJN) (Malawi)

Methodist Tax Justice Network

National Tax Payers 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 - 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)

War on want (UK)

Weltwirtschaft, Ökologie & Entwicklung (WEED) (Germany)