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Submission on IMF Consultation on Economic "Spillovers" in International Taxation

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About WEED

WEED – World Economy, Ecology & Development is a Berlin based specialist think tank and advocacy organization that has worked on the global financial system for almost 24 years. WEED regularly testifies to the German parliament on financial market and tax issues, is a leading member of the German Netzwerk Steuergerechtigkeit (Tax Justice Network) and is engaged in dialogue with civil servants from the German finance ministry. WEED co-authored a report on the "Shadow Financial Centre Germany"[1], dealing amongst others with double taxation treaties. For more information please see www.weed-online.org.

Reply to the Consultation

How does the current network of bi-lateral double taxation treaties, and the spillovers that can arise from treaty shopping, affect low income countries? What changes in the design of treaties could be beneficial for those countries? Is the existence of bi-lateral tax treaties important to the attraction of international capital, and if so why/how?

The current network of DTAs (of course in combination with the rules on transfer pricing) is biased towards the interest of developed countries. Most DTAs follow the OECD model which is designed to favor the interest of the developed countries over the interest of developing countries. Features of the OECD DTA model that seem to be particularly unfavorable are:[2]

1. The narrow definition of a permanent establishment (PE), which assigns to the developed (exporting) countries a higher profit share as e.g. warehouses in developing countries are not taken into account as PE.
2. The limited ability to apply source taxes on dividends, royalties, management fees and similar payments. By limiting source taxes, the (producing) developing countries get less of the profits. Particularly royalties and management fees are known as means for tax avoidance (also through treaty shopping)[3] and thus developing countries should be able to tax them appropriately at the source of the value creation.

The harmful effect is, amongst others, demonstrated by the fact that the United Nations' DTA model addresses these two issues differently and gives developing countries more policy space to have a broad PE definition and higher source taxes. Also German civil servants openly acknowledged the harmful effect when they presented the first official German "negotiation basis"[4] for DTAs last year, admitting that the PE and the source taxation issues are contentious in the negotiations with developing countries, and that Germany aims

[1] Henn, Markus / Mewes, Sarah / Meinzer, Markus (2013): Schattenfinanzzentrum Deutschland. WEED, Misereor, GPF Europe, TJN and Netzwerk Steuergerechtigkeit Deutschland. http://www2.weed-online.org/uploads/schattenfinanzzentrum_deutschland.pdf.

[2] On these and other problems see, for example, Bürgi Bonanomi, Elisabeth / Meyer-Nandi, Sathi (2013): Schweizer Doppelbesteuerungsabkommen: Aktuelle Politik und Entwicklungsrelevanz. Centre for Development and Environment und World Trade Institute, Universität Bern. Study commissioned by the Swiss Foreign Ministry. https://www.cde.unibe.ch/Pages/News/97/Swiss-double-taxation-agreements-Current-policy-and-its-relevance-for-developing-countries.aspx. There is also an English summary on the website.

[3] See for example ActionAid (2013): Sweet Nothings. The human cost of a British sugar giant avoiding taxes in southern Africa. http://www.actionaid.org/publications/sweet-nothings.

[4] German Federal Ministry of Finance (2013): Basis for negotiation for agreements for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital. 22.08.2013. http://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF_Schreiben/Internationales_Steuerrecht/Allgemeine_Informationen/2013-08-22-Verhandlungsgrundlage-DBA-englisch.pdf?__blob=publicationFile&v=5.

for a narrow PE definition and zero source taxation.

Accordingly, just and equitable DTAs should address these issues in the interest of developing countries, but also with other means such as anti-avoidance and anti-treaty shopping rules, subject-to-tax clauses, substance clauses, switch-over clauses, or generally a clear commitment to preventing double non-taxation. The danger of double non-taxation is also prominently addressed in the afore-mentioned German DTA negotiation basis.

How (if at all) does the asymmetric tax treatment of debt and equity contribute to any unintended reduction in the tax bases of individual countries, and of the world's overall taxable profit? What solutions would you prefer, if you see this as a problem?

As detailed in reports by the OECD[5] and others, mismatches regarding financial instruments are a source of tax avoidance. Germany last year also addressed this with a law amendment[6] and the EU is currently revising its Parent-Subsidiary-Directive accordingly. The solution both aim for is to prevent deduction if taxation of a debt instrument would not take place.

Some have argued that it would be also a solution to have an equal treatment of debt and equity by making equity payments deductible from the tax base, as debt interest payments. However, this would just contribute to less taxation of corporations. It would be preferable to do it the other way around and make debt interest payments less or not deductible, as equity.

Have you observed any shifts in capital or investment flows as a consequence of recent shifts in large capital exporting economies toward territorial taxation and away from worldwide taxation?

No comment.

Would an end to deferral of taxation under worldwide taxation regimes (such as that in the US) be beneficial for some countries?

No comment.

Do you have suggestions regarding amendments or the introduction of possible special regimes under the arm's length pricing method that would be of benefit for developing countries, in terms of revenue outcomes and/or administrability?

Generally, the whole arm's length approach seems to be increasingly inappropriate to catch and tax today's global business operations dominated by transnational corporations. This is increasingly acknowledged by institutions such as the OECD in their BEPS documents. It also documented by comments from developing countries. As reported by ActionAid, an advisor to the Zambian government once said: "On transfer pricing, [the ZRA] are, pardon my language, getting f***ed."[7]

However, our impression is that of the existing usual transfer pricing methods profit split is the best option as

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[5] OECD (2012): Hybrid Mismatch Arrangements. http://www.oecd.org/ctp/exchange-of-tax-information/hybridmismatcharrangementstaxpolicyandcomplianceissues.htm.

[6] Gesetz zur Umsetzung der Amtshilferichtlinie sowie zur Änderung steuerlicher Vorschriften (Amtshilferichtlinie-Umsetzungsgesetz - AmtshilfeRLUmsG). http://www.bgbl.de/banzxaver/bgbl/start.xav?startbk=Bundesanzeiger_BGBl&start=//*[@attr_id=%2527bgbl113s1809.pdf%2527]#__bgbl__%2F%2F*[%40attr_id%3D%27bgbl113s1809.pdf%27]__1396287568754

[7] ActionAid (2013): Sweet Nothings. The human cost of a British sugar giant avoiding taxes in southern Africa. http://www.actionaid.org/publications/sweet-nothings. Page 21.

it is based on features related to the real economic activity behind the transaction and not on the nearly impossible attempt to find comparables. It would thus be good to improve this method.

Do you have views on the potential outcomes of an adoption of formulary apportionment and/or unitary taxation—of some degree (including, for example, some form of 'residual profit split')—for developing countries? Other countries? International business? If you support such a system, what allocation factors would you suggest?

Formulary apportionment appears to be a feasible alternative to the current arm's length model even though it will surely not solve all problems arising from international business and time is needed to change the model from the current approach. Next to academic supporters[8], there are also positive comments such as by the Head of Tax of PricewaterhouseCoopers at the UK parliamentary hearing 2013: "It is a system we should look at. It might work."[9]

The question which countries do finally have the benefits and which will lose businesses and taxes it not easy to answer. It is clear that tax havens such as the Netherlands will lose out. We think that developing countries will normally win as they do not get an appropriate share at the moment.

The allocation could be evenly assets, staff and turnover. However, it might be worth thinking about a higher turnover allocation given the internet economy's ability to locate with its servers in any jurisdiction. However, the turnover element should also not be too stressed too much to make sure that the producing countries – providing a lot of infrastructure which require tax income – do not lose out.

How should the international tax architecture treat jurisdictions where significant corporate profits are booked, but which have relatively little substantive economic activity?

Such jurisdictions should be discriminated by rules such as on "controlled foreign corporations", general anti-avoidance rules or substance requirements for affiliates. It is not acceptable that some jurisdictions abuse their sovereignty to create artificial "businesses" and thereby harm other countries.

In your view, does the existence of tax competition—whether directly, through the setting of tax rates, or indirectly, through the shifting of tax bases—serve a useful purpose? Can one identify particular forms of tax competition that are 'harmful'?

It is clear that the worst is the competition just "on paper", i.e. by letter box, conduit and holding companies, where no real economic activity and/or risk is being shifted. This is in fact not even a real competition but only an easy way for corporations to have almost risk-free tax avoidance. It is thus economically and socially undesirable.

However, also the true competition on real foreign direct investments (e.g. a factory, or real services) can be and is often harmful. Just and equal taxation of all companies is only possible in a joint legal – national or global – framework. So if national frameworks are opened up for capital flows and business activities without an according globalization of tax laws, social and working conditions etc., any tax competition will end up with a harmful pressure on the latter.

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[8] Picciotto, Sol (2012): Towards Unitary Taxation of Transnational Corporations. http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf.

[9] House of Commons, Committee of Public Accounts (2013): Tax avoidance: the role of large accountancy firms. Forty-fourth Report of Session 2012–13. Report, together with formal minutes, oral and written. 15 April 2013. http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/870/870.pdf. Hearing minutes page 19.