The International Monetary Fund's Consultation on Economic "Spillovers" in International Taxation

Contribution from the Centre for Research on Multinational Corporations (SOMO) in the Netherlands

Contact person: Katrin McGauran (K.McGauran@somo.nl)

Background and introduction

SOMO is an independent, not-for-profit research and network organisation working on social, ecological and economic issues related to sustainable development. Since 1973, the organisation investigates multinational corporations and the consequences of their activities for people and the environment around the world. See for more information: www.somo.nl

SOMO investigates the impact of tax avoidance by multinationals and harmful tax regimes, with a focus on the role of the Netherlands in providing international tax planning opportunities and investment protection for corporations. In this work, SOMO closely collaborates with its local partners in Africa, Asia and Latin America, the international and Dutch Tax Justice Networks and the European network Eurodad.

SOMO's submission to the International Monetary Fund's tax policy team on Economic "Spillovers" in International Taxation is based on the SOMO report 'Should the Netherlands Sign Tax Treaties with Developing Countries?'[1] This submission only answers the first question of the eight questions posed by the IMF in this consultation.

Question 1A: How does the current network of bi-lateral double taxation treaties, and the spillovers that can arise from treaty shopping, affect low income countries?

The Netherlands provides a large tax and investment treaty network reducing withholding taxes in countries of operation and protecting investments, allows for a number of deductible expenses (such as interest and R&D costs) and other fiscal advantages aimed at attracting international businesses,[2] whilst not applying withholding tax on outgoing payments.[3] These combined factors make the Netherlands one of the world's most important conduit havens:[4] The Netherlands is not a low-tax jurisdiction and not a tax haven in the sense that it offers a near to zero corporate tax rate or bank secrecy, but rather facilitates tax avoidance by letting MNCs channel their investments to low-tax jurisdiction via the Netherlands. Following sustained media and civil society pressure, the Dutch government has recently admitted that the Netherlands often plays a significant and negative role in tax evasion practices of multinationals.[5]

SOMO's research shows that Dutch tax treaties lead to a total annual revenue loss of € 554 million for 28 developing countries because they allow companies to use Dutch conduit entities with little or no material presence in the Netherlands to reduce corporation tax on outgoing payments from subsidiaries in the countries of operation. This is a conservative estimate since only losses on

---

[1] Katrin McGauran (June 2013) 'Should the Netherlands Sign Tax Treaties with Developing Countries?', SOMO report, available at http://somo.nl/publications-en/Publication_3958

[2] For instance, the Netherlands has a fiscal unity regime providing for a tax consolidation of companies within a group and therefore to freely offsetting profits and losses among group members as well as offering advance tax rulings giving certainty on future tax positions.

[3] There is not withholding tax (WHT) on outgoing royalties and interest payments and the applicable WHT on dividends is easy to circumvent.

[4] See for example: *Yahoo, Dell Swell Netherlands' $13 Trillion Tax Haven*. Jesse Drucker - Jan 23, 2013 http://www.bloomberg.com/news/2013-01-23/yahoo-dell-swell-netherlands-13-trillion-tax-haven.html

[5] http://www.rijksoverheid.nl/bestanden/documenten-en-publicaties/kamerstukken/2013/08/30/kabinetsreactie-op-seo-rapport-overige-financiele-instellingen-en-ibfd-rapport-ontwikkelingslanden/kabinetsreactie-op-seo-rapport-overige-financiele-instellingen-en-ibfd-rapport-ontwikkelingslanden.pdf

dividends and interest flows are included. The total revenue loss resulting from Dutch DTAs will be much higher. This is because tax avoidance through profit shifting with the use of royalties and capital gains are not included in the calculations. The estimate illustrates the need for anti-abuse measures in treaties and domestic law to stop companies from 'shopping' for tax treaties to reduce their tax bill in poor countries.

The Netherlands currently has 92 bilateral tax treaties.[6] Seven of these are low income countries[7], 17 are lower-middle-income countries[8] and 24 are upper-middle-income countries[9]. If one would treat upper-middle-income countries and high-income countries as equal treaty partners that are able to mitigate potentially negative effects of bilateral tax treaties, or gain from treaties through increased FDI flows, then roughly 26% of the Dutch tax treaty network can be said to be potentially damaging poor countries revenue through tax avoidance through the Netherlands. The current allocation of taxing rights in bilateral tax treaties reduces tax rates on passive income in source countries, which leads to revenue losses. Given that there is no statistical evidence that these losses in tax revenues are offset by an increase in FDI, this reduction in tax rates has serous negative effects in developing countries. There are clear signs that the Netherlands, like other jurisdictions with a large bilateral DTT network, is used for treaty shopping, leading to a reduction of tax payments by large multinational corporations. Conduit jurisdictions increase the burden of revenue loss without enlarging the invested stock of capital as they are merely used as a conduit. The Dutch government reiterates that the fiscal regime is beneficial to the Netherlands. The question remains whether these gains for the Netherlands are proportionate to the loss developing countries endure.

Question 1B: What changes in the design of treaties could be beneficial for those countries?
With view to development coherence, the Dutch government (and, in addition, other governments concluding tax treaties with developing countries) should therefore change their tax policies to include the following:

- Impact assessment. Institute a comprehensive impact assessment on the impact of DTAs on developing countries before entering negotiations. The definition of developing country should at least include all low-middle-income countries such as India and Indonesia. Inform developing countries wishing to negotiate tax treaties about the conduit role the Netherlands fulfils in the international investment flows.
- WHT. Refrain from negotiating low WHT rates on passive income in tax treaties and generally follow alternatives and source-bias as presented in UN Commentaries to the UN Model Tax Treaty.
- Explore alternatives to DTAs. Seek alternatives for state coordination, tax compliance and harmonised definitions through automatic information exchange agreements, for instance.
- Offer renegotiation of DTAs for developing countries wishing to do so, applying source-bias principles in negotiations.

Question 1C: Is the existence of bi-lateral tax treaties important to the attraction of international capital, and if so why/how?

---

[6] Treaty overview as of 1 January 2013. All countries that have a DTT with the Netherlands are included. The selection is not based on the substantive content of the DTTs. The overview includes Kirgizstan and Turkmenistan, the treaties for which are not available in the Ministry of Foreign Affairs online treaty dabase, but which are included on the list of treaties provided by the Ministry of Finance. For a full list, see http://www.rijksoverheid.nl/onderwerpen/belastingen-internationaal/documenten-en-publicaties/circulaires/2013/01/01/verdragenoverzicht-op-het-gebied-van-directe-belastingen.html
[7] Low-income countries: Bangladesh, Ethiopia, Ghana, Kyrgyzstan, Malawi, Uganda, Zimbabwe (7).
[8] Lower-middle-income countries: Armenia Egypt Georgia India Indonesia Moldova Mongolia Morocco Nigeria Pakistan Philippines Sri Lanka Turkmenistan Ukraine Uzbekistan Vietnam Zambia (17).
[9] Upper-middle-income countries: Albania Argentina Azerbaijan Belarus Bosnia-Herzegovina Brazil Bulgaria China, Jordan Kazakhstan Latvia Lithuania Macedonia Malaysia Mexico Panama Romania Russian Federation South Africa Suriname Thailand Tunisia Turkey Venezuela (24).

The main argument in support of the system of DTTs is that they generate investment flows, in particular between the contracting parties of the agreement. In recent years, there has been a large amount of (mostly quantitative) research on this subject.[10] But in general, there seems to be little evidence that treaties lead to significant more inward investment flows. Other factors, such as political stability, overall levels of economic development and exchange rates appear to be more important determinants of foreign direct investment (FDI). The question remains to what extent DTAs are decisive in investment decisions of MNEs.

In general, Baistrocchi has stated that developing countries engage in FDI and tax competition and sign treaties that are proven to deprive them of tax revenues or restricting policy space and not on grounds of evidence-based policy choices but "for fear of driving FDI away to competing jurisdictions."[11] Even though tax treaties and tax incentives are known to erode the tax base of, in particular, capital-importing countries, developing countries' need for FDI has compelled their governments to view this revenue loss as a necessary evil when competing to attract FDI. As a result of this international tax competition the world has seen a total decline in corporate income tax rates and trade tariffs, and in global revenue. In emerging and developing economies, statutory corporate tax rates (simple averages across countries) have declined since the mid-1990s from about 31% to 26%.[12] The decline has a disproportionally negative impact in resource-rich developing economies, as corporate taxes form a large part of their total tax revenues.[13]

On the related issue of bilateral investment treaties:

SOMO's research aims to uncover the interlinkges between bilateral tax and investment treaties. Bilateral investment treaties provide for legal protection for foreign investors, with the ability to sue governments in international arbitration in the event that the treaty protections are alleged to have been breached. Increasingly, human rights law arguments have, mainly as a defence by states, arisen in investor-state arbitrations.[14] MNCs incorporating in the Netherlands with head offices or mailbox companies can benefit from Dutch bilateral investment treaties (BITs) by making use of investor-state dispute settlement, typically through the World Bank's International Centre for the Settlement of Investment Disputes. There are currently around 95 BITs in force in the Netherlands.[15] The Netherlands has very broad definitions of investor and investment in its BITs and as such they allow mailbox companies to benefit from Dutch bilateral investment treaties by making use of the investor-state dispute settlement.[16] SOMO research has shown that MNCs investing abroad have been using Dutch BITs to sue host-country governments for over $ 100 billion for alleged damages to the profitability of their investments.[17] Several states, including South Africa, Canada and Belgium are involved in bringing investment treaties more in line with modern human rights law and environmental obligations. But most investment treaties, including the Dutch, are silent on the rights of stakeholders other than investors. An investment structure through the Netherlands not only allows companies to

---

[10] S. Rose-Ackerman and J. Tobin, Foreign direct investment and the business environment in developing countries: the impact of bilateral investment treaties, (2005), Yale Law & Economics Research Paper, No. 293; E. Neumayer and L. Spess, Do bilateral investment treaties increase foreign direct investment to developing countries? (2005) World Development 33(10) 1567–1585; J. Yackee, Do Bilateral Investment Treaties promote FDI? Some Hints from Alternative Evidence (2010) Virginia Journal of International Law, 51-2, p. 397-442. UNCTAD, World Investment Report 2003: FDI Policies for Development: National and International Perspectives. New York and Geneva: United Nations 2003) at 53. Fourteen BITs have been signed by Brazil and none are in force.

[11] 2008:355

[12] S. M. Ali Abbas & A. Klemm 'A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies', IMF Working Paper WP/12/28, 2012, p. 7, available at http://www.imf.org/external/pubs/ft/wp/2012/wp1228.pdf

[13] See SOMO, 'Is Foreign Investment Good for Development? A Literature Review for a literature overview and case studies', 2008, available at http://somo.nl/publications-en/Publication_2478.

[14] H. Mann, 'International investment agreements, business and human rights: key issues and opportunities' 13-14, IISD 2008.

[15] For an overview of BITs signed by the Netherlands see http://www.rijksoverheid.nl/onderwerpen/internationaal-ondernemen/documenten-en-publicaties/rapporten/2010/02/22/ibo-landenlijst.html

[16] International Centre for the Settlement of Investment Disputes, https://icsid.worldbank.org/ICSID/Index.jsp (accessed 20 February 2013).

[17] SOMO, 'Dutch Bilateral Investment Treaties. A gateway to 'treaty shopping' for investment protection by multinational companies', 2012, p. 29, available at http://somo.nl/publications-en/Publication_3708, (accessed 20 February 2013).

use Dutch BITs to sue host-country governments but also to put pressure on governments against legislation that could compromise profitability. As such, protection under a BIT can work preventatively by stopping progressive legislation (from a human rights perspective) from being introduced as well as retrospectively by taking governments to court when they have implemented legislation.

International investment treaties inherently limit the domestic policy space of states. The HRC in the UN Guiding Principles on Business and Human Rights calls on states to ensure that they retain adequate policy and regulatory ability to protect human rights under the terms of such agreements. The Dutch government does not, however, seem to recognize that extensive investor protections enable easy circumvention of economic, social or environmental conditions and thereby have negative impacts on the rights to food, education, water, health care, a reasonable standard of life, work and development. In relation to the wider policy context, there is scant recognition in the Netherlands that investor–state dispute settlement based on broad-based BIT definitions can pose a danger to policy space and the safeguarding of human rights, public goods and interests. The Dutch government claims to support companies in fulfilling their responsibility to respect human rights. But as we have seen, at the same time Dutch investment policy hinders the fulfillment of these intentions. SOMO thinks it is definitely possible to make a swift change for the better.

On the link between Dutch tax and investment treaties, the case of Mongolia offers an interesting example. Late 2012, Mongolia cancelled its DTAs with the Netherlands, Luxemburg, Kuwait and the United Arab Emirates because, according to the Mongolian Ministry of Finance, these jurisdictions are primarily used for tax avoidance by large extractive industry companies. The Mongolian Ministry of Finance calculated that as a result of the above-named four treaties the mining project Oyu Tolgoi alone enjoyed unintended tax savings of 45 million euro. The project is a joint venture between the Mongolian government, which owns 34% and Turquoise Hill of Canada, which owns the remaining 66%. Turquoise Hill Resources is majority owned by Rio Tinto. The tax advantages for the investors lie in lower WHT rates on dividends, interest, royalties and reimbursement for technical services laid down in those treaties when compared to existing domestic rates. Apart from the details of this case, a Rio Tinto spokesman told Reuters (2013) in an email that the cancellation of the Dutch treaty will not affect Oyu Tolgoi's use of its Dutch holding company, because the firm has a separate investment agreement with Mongolia which "stabilizes" treaties that were in force in 2009. Rio Tinto said it has and will continue to pay all taxes due under Mongolian law. As Mongolia and the Netherlands have concluded an investment treaty with an umbrella clause, this treaty can be invoked by Rio Tinto to sue the host state for violating the stabilization agreement.