31st of March 2014

Oxfam's contribution to the IMF Public Consultation on economic "spillovers" in international taxation

Oxfam welcomes the opportunity to provide comments on the above-mentioned consultation and recognizes that economic spillovers in international taxation are an important factor to take into account to achieve a fairer international fiscal and financial system.

This consultation comes within the context of the Base Erosion and Profit Shifting (BEPS) process, which Oxfam is following very closely. Such issues are of particular importance for developing countries that depend more from corporate tax revenues than richer economies and are therefore particularly affected by base erosion and profit shifting. We welcome the fact that this IMF consultation focuses specifically on developing country's concerns.

Please find below Oxfam's response to the consultation:

1. 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?

There are approximately 220 tax jurisdictions - countries or autonomous territories with sovereign rights to establish their own tax rules. If every jurisdiction would establish a treaty with everybody else, we would need to foresee a network of 48,400 tax treaties. As of April 2013, there was a total of 5,389 treaties (either double taxation treaties – DTTs - or Tax Information Exchange Agreements) entered into force or in a ratification process.

When negotiating bilateral double taxation treaties countries can follow two models, either one provided by the OECD or another provided by the United Nations tax committee, the latter of which contains provisions that are more beneficial to developing countries.

From double taxation to double non taxation: Despite the initial good intent of the DTTs they have become part of the toolbox for tax avoidance commonly utilized by tax planning professionals. As a consequence, double tax avoidance treaties where the purpose was to avoid being taxed twice on the same income have led to a situation of double non-taxation where income is taxed nowhere.

Creating a complex network of different bilateral rules. Each of these treaties potentially has different clauses such as withholding tax rates for management fees of parent company management, or allocation of tax base of taxable profits between the countries. Multinational corporations can use such differences for tax avoidance purposes to minimize the tax payments in two countries having signed a treaty.

A system that doesn't benefit developing countries: According to a report by Action Aid[1], Ghana and Zambia's governments have lost more taxes a result of signing double taxation treaties with Switzerland and the Netherlands, which reduce the withholding taxes they can charge.

[1] http://www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf

> *"It is striking that the likely tax loss to Ghana and Zambia's governments from the schemes we uncovered has been increased as a result of their double taxation treaties with Switzerland and the Netherlands, which reduce the withholding taxes they can charge on such payments to levels way below the statutory rate."*

According to an independent Dutch research group SOMO, the network of Double Tax Treaties of the Netherlands leads to an estimated revenue loss of up to $771 million for developing countries[2].

Normally, a developing country will make a so-called "withholding tax" on corporate incomes made in the country before they are repatriated abroad to ensure that some tax revenue is kept within the source country. With DTTs, withholding taxes are often seen as creating a risk of double-taxation and are therefore often exempted or reduced without looking at whether the company has paid the correct amount of tax in both jurisdictions. SOMO explains[3] how the Netherlands has a light-touch approach to taxing foreign earned income:

> *"For most countries outside the EU, a withholding tax on outgoing interest is charged by the host country. Under double taxation treaties with developing countries, this withholding tax is reduced to some 10%. At the same time, for the subsidiary in the host country, the interest payments are deductible from corporate income, which is taxed at the host country's national corporate tax rate that may be 30% or more. Income is effectively shifted to the Netherlands."*

Little connections between DTTs and Foreign Direct Investments: Some consider that a large network of DTTs is essential to attracting Foreign Direct Investments (FDI), including the Ghana Investment Promotion Centre[4], but evidence to this effect is not conclusive according to the literature on this subject.[5] In qualitative research findings have found that DTTs have only a minor effect in attracting FDI,[6] while surveys show that investors consider the broadest investment opportunities where a DTT does not play an important part in determining whether profitable investments can be made into the country.[7]

Pakistan for example has presently bilateral tax treaties with 53 countries. According to these treaties, royalties, fees for technical services, interests and dividends are collected at low rates in Pakistan. Substantial amount is remitted at the rate of 10-15% only and the country loses taxes which undermine the state's capacity to allocate sustainable and equitable public financing on education, health and social services. But the 'pressure' to be competitive and attract foreign direct investments made Pakistan adopt these reduced rates in double taxation treaties.

<u>Oxfam is calling for:</u>

1. **Supporting a multilateral tax treaty approach:** the number of tax treaties becomes unmanageable and the bilateral negotiations may be unfavorable for the poor countries. A multilateral approach would bring all bilateral treaties under the same global treaty. Expanding the signatories (especially from developing countries) to the existing Multilateral Convention on Mutual Administrative Assistance in Tax Matters managed by the OECD is an option.

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[2] http://somo.nl/publications-en/Publication_3958
[3] http://somo.nl/publications-en/Publication_2088
[4] http://www.gipcghana.com/invest-in-ghana/why-ghana/tax-regime-and-incentives.html
[5] http://www.vcc.columbia.edu/pubs/documents/Overview-SachsSauvant-Final.pdf
[6] http://unctad.org/en/Docs/iteipcmisc3_en.pdf
[7] http://www.imf.org/external/pubs/ft/issues/issues27/

2. **Developing countries should make a careful cost-benefit assessment**, to whether the lost revenue due to signing a DTT outweigh any benefits as public funds could be used in education, infrastructure and other aspects that improve the broader investor climate.
3. **Reinforcing double tax treaties to prevent them from resulting in no taxation at all**. Consider the European Commission's recommendation to adopt a common General Anti-Abuse Rule, under which countries could ignore any artificial arrangement carried out for tax avoidance purposes and tax instead on the basis of actual economic substance[8].

2. 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?

Oxfam does not have any specific comments on this question.

3. 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?

There isn't enough evidence or research on the pros and cons of a worldwide versus a territorial tax system on developing countries to make a conclusive response.

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

Oxfam does not have specific expertise on this issue, but our initial reflections are: **Deferral taxation could potentially create unpredictability in tax collection**: companies can include deferred taxes as part of their overall tax payments – without the knowledge whether these deferred taxes will ever materialize in actual taxes paid (in the next years).

- **It may encourage misbehavior from companies:** the deferral system dis-incentivizes companies to make profits every year and fosters accounting ruses (profit one year, loss another one) to reduce the overall tax bill.

However, we cannot – to the extent of the evidence – say whether such a move will be beneficial to developing countries. More generally, Oxfam is calling for:

- Greater transparency and disclosure of deferred tax liabilities by the country in which they arise in order to know whether some of the deferred tax liabilities have arisen in developing countries, eroding their revenue bases as a result.
- Public country-by-country reporting so that we know where are the real economic activities of multinationals (where they have subsidiaries, where they employ people, make profits and pay taxes) and whether it matches where they pay their taxes.

8 http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf

5. 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?

The Arm's Length Principle (ALP) dates back from the 1920s and suffers major loopholes in a 21st century economy, as recognized by the G20 and the OECD under the BEPS discussions (Base Erosion and Profit Shifting). Developing countries are among those suffering the most from these loopholes. Tax dodging by multinationals accounts for more than half of total illicit financial flows and close to US $ 500 billion, as a result, are leaving developing countries annually. On this amount, the Global Financial Integrity estimated that the loss of tax revenues on these profit shifting is around US$ 100 billion for developing countries[9].

Several alternatives to the ALP system are worth exploring and additional research should be conducted for example by the IMF. Countries like India, China, Brazil and South Africa have put in place alternatives to the ALP and it would be interesting to look at the impact of these methods if developing countries where to adopt them:

- China[10]: 2007 Corporate Income Tax law with "special tax adjustments" to the ALP aimed at regulating transfer pricing cases. They look at supply chains, and by doing so they test whether the profit allocated to a Chinese subsidiary is appropriate.
- India[11]: Foreign databases are used to determine the "comparable" and arm's length prices, and an arithmetic mean + /- 3% is taken as a basis of calculating the price, recently increased to + / - 5%
- Brazil[12]: Most methods for calculating a transfer price in Brazil come with statutory set of profit margins that vary between 15% and 40% without the need to use "comparable" transactions, which are hard to observe
- South Africa[13]: they make adjustments to take into account the reality of value chains and check arm's length prices according to their detailed sectorial knowledge especially in the extractive industries.

Similarly, several academics have proposed unitary taxation with formula apportionment as an alternative to ALP. Additional research should be conducted to look at the viability of this method.

Developing countries to take part to the international tax reform: The OECD-led discussion on Base Erosion and Profit Shifting (BEPS) provides a welcome and vital opportunity to renovate the wrecked and antiquated international tax system. However, the BEPS action plan has a fundamental flaw: it excludes all countries that are not members of the OECD and G20 from deciding the new rules. Developing a 'multilateral instrument' and set of measures that excludes at least four fifths of the world's governments, not only runs the risk of repeating the dynamics behind the current fragmentation of international tax standards and practices, but is deeply iniquitous.

6. 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

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[9] http://www.gfintegrity.org/storage/gfip/documents/reports/implied%20tax%20revenue%20loss%20report_final.pdf

[10] Ying, Z. 2012 'China's transfer pricing system', presentation made at 'Transfer Pricing Seminar', Helsinki 13-15 June, 2012, organized by KEPA, Tax Justice Network and Government of Finland. Available at: http://www.taxjustice.net/cms/upload/pdf/Zhang_Ying_1206_Helsinki_ppt.pdf

[11] Vijayaraghavan, V. 2012 'Indian Transfer Pricing System' presentation made at 'Transfer Pricing Seminar', Helsinki 13-15 June, 2012, organized by KEPA http://www.taxjustice.net/cms/upload/pdf/Vikram_Vijayraghaven_Helsinki_1206_ppt.pdf,

[12] http://www.amiando.com/eventResources/q/7/rHePEjzvEfeNWD/Dao_Real_Santos.pdf

[13] http://www.amiando.com/eventResources/E/M/tcV678qvSmILvT/Gerdi_Van_Westhuysen.pdf

split')—for developing countries? Other countries? International business? If you support such a system, what allocation factors would you suggest?

Many low-income countries have adopted legislation following the OECD model treaty, thus including the "arm's length principle" as the guiding basis – and in some cases more detailed legislation concerning the methods allowed to calculate such prices and documentation that needs to be provided.

The key concern is whether the rules promoted by the OECD are applicable to the poorest countries, and the experience of the BRICS countries shows that they have all made adjustments to the standard OECD rules in order to reduce the extent or tax avoidance that is common in transfer pricing cases. Developing countries also need to be able study the unitary taxation methods that are in place either in the USA[14], Canada and Switzerland[15], as well as alternatives arising from supply-chain analysis in BRICS countries and come up with the most suitable solution for their needs as the current system of transfer pricing as it is promoted by the OECD is broken.

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

Dealing with such jurisdictions, that we call 'tax havens', is first and foremost a matter of political will. Five years ago, G20 leaders declared an end to bank secrecy and vowed to clean up the international tax system. This was in response to the role financial secrecy and murky tax rules had played in causing the financial crisis. Leaders also committed to, '*by the end of 2009, make it easier for developing countries to secure the benefits of a new cooperative tax environment*.' It is only now, five years on, that any meaningful action against secrecy and corporate tax dodging may be delivered, largely in response to budgetary pressure in their own domestic economies as fall-out from the crisis,

Overall greater transparency is needed to fight tax havens and tax dodging by those using these jurisdictions: ensure full public country-by-country reporting for large companies in all sectors (to know where they have real economic activities and where they pay their taxes), having public registries where to find information on beneficial owners of companies, trusts and other corporate vehicles (to know who is the real human being behind companies to avoid misuse of shell companies for tax evasion) and a global system of automatic information exchange where developing countries will participate (even if they only receive information at the beginning and do not exchange any, if they don't have the capacity) so that developing countries can fight tax dodging too.

The listing exercise done by the OECD to highlight which countries are tax havens has not proved to be very useful so far, but regional coordinated positions to impose sanctions on countries considered as tax havens (e.g. higher customs tariffs) or on companies using these tax havens (e.g. withdrawing banking licenses for banks for example, ban from public procurement contracts etc…) should be envisaged.

Finally, economic substance tests should be made by developing country tax and regulatory administrations and if they feel that there is not sufficient transparency and economic substance, they could consider imposing withholding tax rates on any income shifted to such a low-tax jurisdiction

[14] http://www.taxjustice.net/cms/upload/pdf/Michael_McIntyre_1206_Helsinki.pdf
[15] http://www.amiando.com/eventResources/K/O/ltG8fIZev0z980/Erika_Dayle_Siu.pdf

where companies book profits as a counter measure, as is already the case with Brazil,[16] Ecuador, Argentina and other developing countries in Latin America in particular.

8. 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'?

Tax rates are ultimately a sovereign decision of each state and tax competition is therefore a logical consequence of this sovereign right. **However, tax competition can be considered as harmful when it leads to a race to the bottom, when countries are incentivized to reduce their tax rates, especially to attract FDIs.**

Almost every country in sub-Saharan Africa offers tax holidays, while in Latin America and the Caribbean there has been a major proliferation in this type of stimuli. The most widespread tax incentives used by developing countries to promote investments are tax holidays and `special development' or free trade zones. A tax holiday is a temporary reduction or exemption from tax for companies. Tax holidays are used to promote investment based on zero taxation over a period of time. When there is a tax holiday, profits are exempt during this time from tax regardless of their size. An analysis of 40 developing countries studied in 2001 showed that 58% of them used temporary tax expenditures for investment, 60% used reduced taxation rates and 45% had free trade zones.

Despite their proliferation, there is little evidence of the positive impact of these incentives on countries' development. Between 1990 and 2001 the reduction in corporate taxes in developing countries accounted for a drop of nearly 20% in these countries' tax revenue. Peru is a good example: despite a very progressive tax system originally, Peru's income tax does not bring in much revenue for the country, primarily because of the enormous number of deductions and tax incentives. In 2008, a new reform reduced the taxation on income from capital to a fixed rate of 6.25%. This reform was justified by the government on the grounds that it would prevent capital flight to tax havens. Free trade zones are also sometimes exposed as havens for national capital allied with foreign capital to evade taxes, such as in Nicaragua.

There is substantial evidence on the harmful impacts of tax competition, for instance in the context of East Africa (see Tax Justice Network-Africa and ActionAid report[17]) "*In total, Kenya, Uganda, Tanzania and Rwanda are losing up to US$2.8 billion a year from all tax incentives and exemptions. Not all of these mechanisms are bad. Some, such as VAT reductions, can help reduce poverty. But much of the revenue loss is explained by tax incentives provided unnecessarily to attract foreign investment. These revenue losses are depriving countries of critical resources needed for reducing poverty*." Tax exemptions are given in all of the four East African countries to a wide range of industries, but in particular to those industries that establish themselves in Export Processing Zones (EPZ) or Special Economic Zones (SEZs).

[16] http://www.fazenda.gov.br/portugues/releases/2010/junho/r080610b.asp
[17] http://www.actionaid.org/sites/files/actionaid/eac_report.pdf