Submission to the International Monetary Fund's Consultation on Economic "Spillovers" in International Taxation

ActionAid International

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About us

ActionAid is an international NGO working in 45 countries worldwide. Our positions and recommendations reflect the experiences of our staff and partners in Africa, Asia, the Americas and Europe. Our vision is a world without poverty and injustice in which every person enjoys the right to a life with dignity. We work with poor and excluded women and men to eradicate poverty and injustice. In 2003 we became ActionAid International and moved our global headquarters from the UK to South Africa. Our rights based approach, which looks at the systemic causes of poverty, forms the foundation for our work on development financing, including taxation. We continue to play a leading role in debates and campaigns around the world on tax justice and mobilising domestic resources to fight poverty.

For more information on our work, and to discuss any of the issues covered in this submission, please contact Anna Thomas (anna.thomas@actionaid.org).

INTRODUCTION AND RECOMMENDATIONS

- International efforts to revise corporate tax rules are currently focused on the erosion of individual countries' and companies' tax bases. Though assessments differ about the scale of this problem, there is now widespread consensus that it exists, and that it is particularly large for developing countries: as the IMF has reported from its technical missions, in some cases perhaps 20 percent of all tax revenues in particular developing countries.

- These international reform efforts are extremely welcome, but in general are not currently considering the international distribution of the corporate tax base, and of taxing rights.[1] Yet changes to large economies' tax regimes - including measures they may implement to counter 'base erosion and profit shifting' - will necessarily affect the balance of taxing rights and the international distribution of the tax base, even if it is not those measures' primary intention.

- Though insufficiently acknowledged in current international tax initiatives, therefore, both the problem of corporate tax avoidance, and potential solutions to it, will create winners and losers amongst different kinds of economies, raising issues of inter-nation equity of real concern for the public revenues of the countries where ActionAid works. Assessing such winners and losers requires economic analysis as much as tax legal analysis. The IMF's Fiscal Affairs Division is well-placed to provide the former in complement to the more legally-oriented work of the OECD's Centre for Tax Policy and Administration, the UN's Committee of Experts on International Tax Matters, and other pools of expertise.

- The IMF has already taken a valuable lead in highlighting the 'spillover impacts' of major G20 economies' tax policies: both direct impacts through setting limits on developing countries' taxing rights in trade tariff and double taxation agreements, as examined in recent IMF policy advice to Mongolia, for example; and indirect impacts through G20 members' domestic tax regimes, and particularly their tax treatment of foreign income, as highlighted by the Fund's joint report to the G20 Development Working Group in 2011.

- The major task now is to provide the analytical framework and methodological tools for policymakers to fulfil the G20's 2013 communiqué commitment "*to examine how our own domestic laws contribute to BEPS and ensure that…our own tax rules do not allow or encourage any multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions"*: a commitment which is yet to feed into national tax policymaking.

- We therefore strongly welcome the IMF's programme of work to examine international tax spillovers on low-income countries; and are grateful for the opportunity to submit our views and experiences on this topic. Our recommendations draw upon ActionAid International's own research on corporate tax behaviour and national tax policymaking in a number of African and Asian countries, and our discussions with tax authorities in the countries where we work.

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[1] E.g. OECD, *Action Plan on Base Erosion and Profit Shifting* (July 2013), p. 11: *"In the changing international tax environment, a number of countries have expressed a concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence States….[T]hese actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income."*

FOUR KEY RECOMMENDATIONS:
MACROECONOMICS, MEASUREMENT, INTER-NATION EQUITY & 'INDIRECT' SPILLOVERS

1) **<u>The macroeconomics matters</u>. Impacts on international financial stability and economic performance should be integrated into tax policy analysis.**

National policymakers' analysis of the international impact of new tax policies should not be confined – as they commonly are - to impacts on revenues and investment flows, important though these are; but should also examine broader impacts on (i) financial stability, (ii) debt and deficit management, and (iii) policy coherence for development. We hope that these will also be major contributions of the IMF's work to the international tax reform debate.

Taking into account these broader systemic effects may identify win-win outcomes from efforts against cross-border tax avoidance, the rationalisation of tax incentives and exemptions, or increases in source taxation, even where such measures may be conventionally regarded as introducing 'production inefficiencies'. For example:

- greater source taxation of cross-border interest payments may be a simple and effective instrument against the destabilizing over-leveraging of firms' balance sheets; and may be more politically feasible than directly altering the asymmetric tax treatment of debt and equity *[question 2]*;
- boosting tax take in developing countries through source taxation, and in both developing and developed countries by limiting the territorialisation of capital-exporting countries' tax systems *[question 4]*, may assist in wider efforts to reduce national deficits, with collective international benefits for economic performance and stability;
- permitting greater taxation of cross-border income at source, particularly in tax treaties, may redistribute the tax base towards low-income countries, with benefits for ending those countries' dependence on international aid often provided by capital-exporting 'residence' countries *[question 1]*.

2) **<u>Measurement matters</u>. One of the most valuable contributions that the IMF's tax spillovers work could make going forward is to develop workable methodologies for G20 finance ministries to quantify the international spillovers of their tax regimes, particularly bilateral tax treaties.**

Extensive tools exist to model the effect of national tax measures on tax <u>incidence</u> on different income groups <u>within</u> economies; few to examine their impact on the differential <u>allocation</u> of taxable base and taxing rights <u>between</u> economies, and particularly across different country income groups.

This is obviously a complex area with challenges from the lack of availability of (particularly firm-level) data. One simpler area to take forward first, building on existing IMF country technical advice, could be methodologies for quantifying the spillovers of new or existing bilateral tax treaties *[question 1]*, which would be confined to spillovers between one pair of countries only; and which could be based on bilateral data on investment and income flows that a developed treaty partner's

central bank is likely to be able to collect itself. This analysis could later be made dynamic to take account of changes in FDI geography due to treaty shopping; but as this is a new area, static bilateral analysis should be prioritised.

Ultimately, though it might be analytically complex, a baseline measurement of the 'international tax-base progressivity' of the current distribution of the corporate tax base would help with subsequent assessments of national and international tax spillovers, and would be a valuable way of taking forward the recommendation for a baseline spillover study made by international institutions to the G20 Development Working Group in 2011. While such a baseline measurement is currently hampered by the scarcity of firm-level data in developing countries, emerging standards for country-by-country reporting for multinational groups headquartered in EU or OECD member states may help fill this data gap in future years.

3) **<u>Inter-nation equity matters</u>. Proposals to stop base erosion and profit-shifting should aim not just to prevent double non-taxation and align the tax base with economic substance, but explicitly to protect lower-income countries' tax bases and taxing rights.**

This may include prioritizing solutions that permit countries simply to enhance source taxation of cross-border income, rather than narrower technical anti-abuse rules that may be difficult for less well-resourced tax authorities to apply, and which may not in any case grant them more revenue or taxing rights *[questions 1, 4, 5].* In a world of increasingly territorial tax systems in major capital-exporting economies, such measures do not have to deny tax base to 'residence' states; and in a world of increasingly unilateral tax credits, they do not have to lead to double taxation. Indeed, the absence of source taxation can otherwise lead to double non-taxation in many cases.

4) **<u>Indirect spillovers matter</u>. "Vertical" pressure on developing countries' tax bases and rates, particularly from the territorialisation of capital-exporting countries' tax systems, should be a priority for the IMF's analytical and methodological work under the 'tax spillovers' strand.**

Although difficult to measure in aggregate, nonetheless ActionAid's own firm-specific research strongly suggests that 'vertical' pressure from excessively wide exemptions of foreign income in major G20 capital-exporting economies can have as significant an impact on developing countries' revenue bases as 'horizontal' tax competition between developing countries, or profit-shifting into jurisdictions more commonly labelled 'tax havens' *[questions 4, 7, 8]*. Yet multilateral initiatives against harmful tax regimes (EU, OECD and EAC) have thus far focussed almost exclusively on 'horizontal' tax competition, and not on this kind of indirect tax spillover, which the IMF has previously highlighted in its work for the G20 DWG.

To fill this analytical gap, and to help G20 countries fulfil their 2013 commitment to ensure their own tax regimes do not promote base erosion and profit shifting, it would be valuable for the IMF's spillovers work to prioritise this kind of 'vertical' spillover.

OTHER RECOMMENDATIONS

Tax treaties *[question 1]*:

- Low-income countries' revenues are often harmed not only by treaty abuse/shopping, but by normal treaty 'use' where capital and income flows between treaty partners are predominantly in one direction. Given the absence of conclusive evidence that such revenue sacrifices do indeed deliver investment, jobs or growth for low-income countries, initiatives to tackle treaty abuse should not just update inadequate anti-abuse protections of old treaties, but address the balance between source and residence taxing rights.

Debt/equity tax treatment *[question 2]*:

- Proposals to reduce base erosion by equalising the tax treatment of debt and equity must ensure that they would not erode the tax base too much for low-income countries, dependent to a greater degree than other income groups on corporate income tax; nor open up new opportunities for tax arbitrage.
- For low-income countries, greater source taxation of cross-border interest payments may be simpler, more effective, less base-eroding and more politically feasible.

Transfer pricing *[question 5]*:

- Our discussions with revenue authorities suggest there would be benefits from greater latitude for all countries, including developing countries, to apply simpler benchmarks, fixed margins or ceilings in transfer pricing. These include both the kinds of fixed-margin methods developed by Brazil and others; and also benchmarks and deductibility limits already applied by some developing countries to royalty payments, management and marketing fees to limit foreign exchange loss and incentivise technology transfer.
- Such measures do not have to generate more unresolvable double taxation than current OECD pricing methods; would be more administrable; and if applied more strictly to cross-border transactions with related parties in low-tax jurisdictions or enjoying low-tax preferential tax regimes, would help counteract base-erosion and profit-shifting.

Unitary taxation *[question 6]:*

- Current methods for allocating taxable income and profits between countries are not working well for many developing countries, and consideration of proposals to change the system fundamentally is welcome. Such fundamental changes, including international unitary taxation, deserve serious technical analysis of their likely impacts, rather than being ruled out summarily on grounds of supposed political feasibility.
- Of course, designers of any fundamental reform should ensure that it does not excessively disadvantage the tax base or tax revenues of low-income countries; and that such impact can be mitigated. The comparison should not simply be whether a given formula or allocation key would allocate more or less profits to wealthier countries; but whether the inter-nation equity of this allocation would be better or worse than under present separate-entity and OECD-authorised transfer pricing methods.

- A baseline measurement of the 'international tax-base progressivity' of the current corporate tax base, consonant with the recommendation for a baseline spillover study made by international institutions to the G20 Development Working Group in 2011, would help with this comparison.

Aligning the tax base with economic activity *[question 7]*:

- We believe international tax initiatives should focus not only on specific jurisdictions, but on the nature and impact of tax regimes, wherever they are located.
- They should also look beyond 'substance requirements', the current focus of much international effort to align profits with economic activity. These are important, but in practice are often easily side-stepped, and are not always applicable to base-eroding activity. Instead, harmful tax regimes should be identified in part on the basis of measurements of their fiscal and wider economic harm (negative spillovers), particularly to low-income countries, as much as on the basis of a typology or criteria relating to the nature of the tax regime (preferential, 'ring-fenced', not requiring substance, and so on).
- Effective measures to align the tax base with economic activity in low-income countries must encompass (i) source-based measures, including greater latitude for both developed and developing countries to impose higher taxes on/limit the tax-deductibility of/set pricing ceilings on cross-border transactions enjoying harmful tax regimes in the other state; (ii) residence-based measures in developed capital-exporting economies, including CFC regimes that apply 'headquarter' taxes to low-taxed income irrespective of where that income has been shifted from; and limits to foreign income exemptions in instances where the income has been subject to low- or no-tax in the country of source; (iii) collective measures to directly address harmful tax regimes, including emerging efforts by developing country groupings against harmful tax competition, like the standards proposed within the East African Community and the West African Economic and Monetary Union. These deserve greater international support, and should not be undermined by G20-headquartered multinational firms seeking discretionary tax incentives.

Tax competition *[question 8]*:

- Collective action to define and mitigate harmful tax competition should include not just 'horizontal' tax competition, as at present; but also indirect 'vertical' pressure on low-income countries' tax bases and rates generated by large capital-exporting economies' efforts to attract corporate headquarters and facilitate outward FDI.
- Though pursuing capital import neutrality is a sovereign tax policy choice, and might not in itself be labelled harmful, measures in pursuit of capital import neutrality which indirectly facilitate double-non-taxation, or which reward profit-shifting to low-tax jurisdictions, should be identified as harmful and counteracted.

What we mean by tax spillovers

While no agreed international definition exists, in this paper we understand 'negative tax spillovers' to mean (i) the erosion of a country's taxable base, or (ii) pressure on a country from changes of cross-border income flows or investment stocks/flows to reduce its tax base or tax rates; where these effects are generated either by the national tax regime of another country, or by bilateral tax agreements.

In identifying negative tax spillovers, we find it analytically useful to distinguish between two kinds of spillover:

- **Direct 'horizontal' spillovers:** base erosion/profit shifting, or tax-competitive pressure, generated by another country using tax policy to attract businesses, economic activity or income from other countries;

- **Indirect 'vertical' spillovers:** pressure on a country's tax rates or tax base from the tax treatment in other countries of cross-border capital or income, including those generated by moves in capital-exporting countries towards more territorial tax systems. Such moves essentially affect the sensitivity of the effective tax rate of a multinational group headquartered in the capital-exporting country to changes in the tax rate in a given country where it operates, thereby both reducing fiscal space for those countries, and potentially incentivising profit-shifting from those countries into lower-tax jurisdictions.

RESPONSES TO SPECIFIC CONSULTATION QUESTIONS

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?

1.1 While evidence suggests that tax treaties affect the routing of foreign direct investment, ActionAid's experience in observing treaty policy in both developing and developed countries where we work suggests that policymakers' belief that tax treaties generate significant new inward investment that would not otherwise have taken place is often considerably stronger than the economic evidence for it.

1.2 We note that while quantitative studies have found positive and negative effects of tax treaties on both developing and developed countries, very few have found a positive impact on FDI into low-income countries as a result of tax treaties.[2] This makes sense in view of the wider literature on tax considerations in cross-border investment decisions, which in many cases has found that tax is rarely a first-order consideration in situations where other aspects of good investment climate - from infrastructure to political stability - are not in place, as in many low-income countries where the achievement of such an investment climate often relies upon government resource mobilisation to begin with.[3]

1.3 Some recent studies using dyadic data have found tax treaties to increase investment into developing countries from specific treaty partners; but these are nonetheless prone to limitations in FDI data which generally do not establish FDI's immediate source from its ultimate origin, and thus cannot distinguish between investment genuinely originating in the treaty-partner jurisdiction from 'treaty-shopping' FDI simply routed through the new treaty partner jurisdiction.[4] Equally, it is difficult to determine the direction of causality, particularly where treaties have been in force for some time: whether treaties cause additional investment, or whether key existing sources of FDI are 'rewarded' and consolidated using a treaty. Finally, we have been unable to identify any systematic analysis of the effect of tax treaty content on FDI flows, and thus no sound evidence that, beyond the signaling effect produced merely by the existence of a treaty, a capital-importing country ceding more taxing rights in one treaty negotiation than another will generate more FDI than without such sacrifice.

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[2] A substantial set of recent studies are presented in K.P. Sauvant and L.E. Sachs (eds.), *The Effect of Treaties on Foreign Direct Investment* (Oxford: 2009).

[3] T. Kinda, *The Quest for Non-Resource-Based FDI: Do Taxes Matter?*, IMF Working Paper WP/14/15, January 2014; E. Mwachinga, *Results of investor motivation survey conducted in the EAC*, World Bank, presentation given 12 February 2013 in Lusaka, http://bit.ly/14B0AqE; B.K. Kinuthia, *Determinants of foreign direct investment in Kenya: new evidence*, paper submitted to the African International Business and Management Conference, Nairobi, August 2010, http://bit.ly/16ngfd6

[4] F. Barthel, M. Busse, E. Neumayer, "The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence From Large Dyadic Panel Data," *Contemporary Economic Policy 28, No. 3* (December 30, 2009), pp.366–377. For a study that supports the view that withholding-tax-reducing treaty networks like that of the Netherlands generates treaty shopping, see F. Weyzig, "Tax Treaty Shopping: Structural Determinants of Foreign Direct Investment Routed through the Netherlands," *International Tax and Public Finance* (11 September 2012).

1.4 Ambiguous evidence does not mean that tax treaties can never attract new FDI, but that in any given case it cannot be assumed or guaranteed. Yet in our experience, policymakers in both developed and developing countries often fail to undertake evidential assessments to determine the revenue impact, investment impact or wider economic impacts of a given proposed tax treaty.[5] **We believe that assessing the revenue, investment and other economic impacts on both treaty partners should be a basic requirement when developed countries are considering signing tax treaties with developing countries.** The development of more robust methodologies for modelling a treaty's likely impacts on both treaty partners, taking into account likely dynamic changes in investment and income flows across borders, would help a great deal, and the Fiscal Affairs Division's spillovers work could contribute valuably to developing such methodologies.

1.5 The revenue impacts of treaty shopping are clearly significant, and can be particularly significant for low-income and lower-middle-income countries with limited revenue bases and higher reliance upon a small number of large corporate taxpayers. ActionAid has come across examples in Zambia, for instance, in which treaty shopping transactions undertaken by a single multinational group, exploiting two unbalanced treaties with Ireland and the Netherlands, may have cost the Zambian government some $17.8m in revenues between 2007-12: a small sum for a developed country's fisc, but in Zambia sufficient to finance an extra child's primary school education every 12 minutes during that period.[6]

1.6 Since developing countries' most imbalanced tax treaties – those most amenable to treaty shopping - are often those with former colonial powers and other European countries which are also significant aid donors to those developing countries, the negative spillover effects of imbalanced treaties with aid recipients are a particularly acute example of development 'policy incoherence'. For instance, our Zambian study found that since 2007 a single company's treaty shopping activities exploiting Ireland's uniquely imbalanced tax treaty with Zambia – also one of Ireland's nine 'development partners' - may have deprived the Zambian government of revenues equivalent to one in every €14 of Irish development aid provided to Zambia during that time.[7]

1.7 **However, negative spillovers from large treaty networks on the revenue bases of developing countries are not confined to the artificial engineering of entitlement to treaty benefits by an entity in a third country (treaty shopping).** They may also be generated by the straightforward application of a nonetheless unbalanced tax treaty involving treaty partners between whom capital, services, expertise or payments for intellectual property primarily flow in one direction – as is

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[5] The absence of such assessments by policymakers is striking even in countries with well-developed treaty policies and well-resourced finance ministries, such as the United Kingdom. The statement of the responsible UK Finance Ministry (Treasury) minister to the UK Parliament, when asked to provide revenue impact assessments for new and revised double tax conventions signed by the UK in 2012, is typical: "*the traditional question that arises when we consider such orders… is about their revenue implications. …The question is perfectly reasonable, but it is difficult to answer, because it is not possible to put a precise figure on the revenue effect of any of these agreements, or of the agreements as a whole. The overall cost or benefit of an agreement is a function of the income flows between the two relevant countries, and any agreement is likely to change the volume and nature of those flows by encouraging cross-border investment. I therefore fear that I cannot provide an answer*" (UK Commons Hansard, 5 November 2012, Col. 7, http://www.publications.parliament.uk/pa/cm201213/cmgeneral/deleg1/121105/121105s01.htm

[6] M. Lewis, *Sweet Nothings: The Human Cost of a British Sugar Giant Avoiding Taxes in Southern Africa* (London: ActionAid UK, 2013), http://www.actionaid.org.uk/sites/default/files/doc_lib/sweet_nothings.pdf

[7] M. Lewis, *Sweet Nothings: The Human Cost of a British Sugar Giant Avoiding Taxes in Southern Africa* (London: ActionAid UK, 2013), http://www.actionaid.org.uk/sites/default/files/doc_lib/sweet_nothings.pdf

frequently the case in treaties between developed and developing countries, and between high- and low-tax jurisdictions.

1.8 A straightforward, common example is the relocation of intellectual property such as African-specific brands from African countries to 'IP-friendly' jurisdictions with large treaty networks, including some European countries, to which substantial intra-group royalty charges can then be made.[8] For example, the Netherlands' generous amortization rules for IP, and other low-tax measures such as the 'Innovation Boxes' or 'Patent Boxes' becoming increasingly common within the European Union, allow the returns to such intangible assets to be taxed at a very low (or even nil) effective rate; and as long as an exit charge can be avoided when the intellectual property is first moved, then other efforts to prevent such base erosion, such as the application of domestic withholding taxes on the royalty payments at source, will generally be restricted by treaty. The combination of treaty limitations and low-tax domestic environments for mobile income in 'treaty havens', including within the EU, may thus be an invitation to base-eroding payments from lower-income countries; an incentive for manipulating returns to intangible assets; and also a wider disincentive to multinational businesses locating higher-value functions like management and research/development in developing countries themselves, denying them the economic development benefits that such functions can bring.

1.9 Efforts to prevent base-eroding effects of tax treaties that are confined only to updating old treaties to include anti-abuse measures, or to developing more sophisticated anti-treaty-shopping measures,[9] will thus fail to capture many of the situations of substantial concern to low-income countries. These include limited source taxation of offshored intra-company services;[10] payments – even if not mispriced – for the use of intellectual property developed onshore and deriving value substantially from 'onshore' markets, but moved offshore into a treaty partner;[11] and the inability to tax capital gains of an asset's or company's offshore owner. By contrast, treaty design which increased source taxing rights – through significant withholding tax rates on royalties/interest/dividends, source taxing rights on services income, and greater source taxing rights on capital gains from the alienation of shares - would not only disincentivise base-eroding transactions such as treaty shopping far more straightforwardly and reliably than the application of complex and contestable anti-abuse clauses, but also protect developing countries' tax bases more broadly in treaty relationships with developed countries.

1.10 Significantly, increasing source taxation does not have to increase double taxation, nor necessarily deprive developed the corresponding treaty partners of tax revenues. Source taxation, including withholding tax, is widely creditable in residence states (credits which are also often provided unilaterally in many capital-exporting countries, without the need for a tax treaty). The levying of withholding taxes on gross rather than net income does raise the possibility of there being

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[8] An example is detailed in M. Hearson & R. Brooks, *Calling Time: Why SABMiller should stop dodging taxes in Africa* (October 2010), pp. 23-24.

[9] See, for example, the proposal by the OECD BEPS project to insert purpose-based anti-abuse clauses and 'limitations of benefits' provisions into new and existing treaties: OECD, *Public Discussion Draft: BEPS ACTION 6: Preventing the granting of treaty benefits in inappropriate circumstances* (17 March 2014), http://www.oecd.org/tax/treaties/discussion-draft-action-6-prevent-treaty-abuse.htm

[10] See e.g. the discussions on the taxation of services in the 9th session of the UN Committee of Experts in Tax Matters, 21-25 October 2013, http://www.un.org/esa/ffd/tax/ninthsession

[11] M. Hearson & R. Brooks, *Calling Time: Why SABMiller should stop dodging taxes in Africa* (October 2010), pp. 23-24.

insufficient taxable net income in the residence state against which to provide a full credit; but for investment income with fewer associated costs this is less likely to be the case. Moreover, as developed countries increasingly territorialise their tax bases *[questions 4, 8]* to exempt some forms of foreign income from tax altogether, source taxation may no longer threaten juridical double taxation to the same extent as previously. In such cases the treaty policy of many major capital exporters to the developing world (for instance, the two largest sources of FDI into sub-Saharan Africa, [12] the Netherlands[13] and the UK[14]) to limit or eliminate source taxation in their tax treaties, while often described as an effort to reduce double taxation, in practice simply constitutes an effort to reduce effective rates of (single) taxation on multinational taxpayers' income overseas. ActionAid believes that effective rates of taxation on income arising in a given country is properly the subject of domestic tax policymaking and political debate in that country, and in the absence of risks of double taxation that cannot be relieved in other ways, should not restricted in perpetuity by treaty.

1.11 Nor are the negative spillovers caused by imbalanced tax treaties confined to older or outdated treaties, as in the Ireland-Zambia case discussed above. Many newly-signed treaties signed by low- and lower-middle-income countries are equally imbalanced. Several treaties recently signed between Mauritius and other African countries, for example, contain a capital gains article reserving all capital gains taxation to the state of the investor's residence, while Mauritian tax rules effectively exempt Mauritian investment companies from capital gains tax.[15] These recent treaties seem likely to invite 'round-tripping' of domestic investment in the African countries concerned, and are in any case likely to deny these countries the ability to levy tax on the gains from the sale of domestic businesses, mines, oil extraction rights and much else, if owned by investors via a Mauritian holding company. This is potentially a serious handicap to these governments' ability to benefit from the value of their natural resources, productive sectors and burgeoning consumer markets in the future.

1.12 It is thus not simply the inadequate anti-abuse protections of old treaties, but the imbalance between source and residence taxing rights in the current UN and OECD model treaties, that significantly generates negative spillovers for developing countries. Models matter: our discussions with developing-country treaty negotiators confirms that, as international norms and internationally accepted starting points for treaty negotiations, model treaties provide backstops to resist pressure from prospective treaty partners to forego taxing rights in return for the promise of FDI. Developing countries may propose alternatives to both main models, but these rarely succeed in treaty negotiations, as the example of Nigeria demonstrates: a developing country with a well-defined treaty policy and its own model treaty, whose heterodox provisions on shipping, capital gains and directors fees have very rarely been successfully included in Nigeria's treaty network.[16]

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[12] ActionAid calculation from IMF CDIS database, queried for years 2010-2012.

[13] Ministerie van Financiën, *Notitie Fiscaal Verdragsbeleid 2011* (11 Febuary 2011), http://www.rijksoverheid.nl/bestanden/documenten-en-publicaties/notas/2011/02/11/notitie-fiscaal-verdragsbeleid-2011/notitie-fiscaal-verdragsbeleid-2011-met-omslag.pdf

[14] See ministerial statements in the UK Parliament's Delegated Legislation Committee, 5 November 2012, http://www.publications.parliament.uk/pa/cm201213/cmgeneral/deleg1/121105/121105s01.htm

[15] For example, the Mauritius-Kenya and Mauritius-Nigeria treaties signed in 2012.

[16] Presentation by Belema Obuoforibo (International Bureau for Fiscal Documentation) to Maastricht University Global Tax Policy Conference, Amsterdam, 6 March 2014.

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?

2.1 ActionAid's firm-level investigations suggest anecdotally that thin capitalisation through related-party loans, incentivised by the asymmetric tax deductibility of interest compared to (non-deductible) profit distributions, is a significant problem for the tax bases of some low- and lower-middle-income countries. In addition, where tax rules incentivise taking on *unrelated* party financing as debt rather than equity, it is possible they may also encourage the destabilising and excessive leveraging of firms that may contribute to transnational financial crises, as IMF staff work has suggested.[17]

2.2 In theory, thin capitalisation can be more straightforwardly counteracted in domestic tax law than some other base-eroding payments, by imposing thin capitalisation ratios which limit interest deductibility over a given debt-to-assets ratio, a given interest cover, or a given related-party-debt-to-equity ratio. **There is little systematic evidence, however, about the effectiveness of thin cap rules in low-income countries specifically.[18]** ActionAid has identified one example, at least, where the thin cap rules of a developing country – forbidding the carrying forward of tax losses generated by interest payments on related party loans above a maximum related party debt-equity ratio of 2:1 – have been simply disregarded by a multinational affiliate which has thinly capitalised itself through an inter-group loan to a ratio of over 7:1.[19] Better-resourced tax authorities might challenge this outcome, but there are also other straightforward mechanisms for avoiding thin cap limits that present difficulties even to well-resourced tax authorities: including 'back-to-back' loans to interpose an unrelated party (usually a bank) as the immediate lender; and 'bed-and-breakfasting', the manipulation of debt levels during a reporting period to escape a thin cap ratio (and sometimes also to conceal leverage levels to investors, an indication of the wider impacts on financial instability of excessive debt deductibility).[20]

2.3 **Instead of playing 'catch-up' with such avoidance techniques, several proposals have been made either to make the tax treatment of debt/equity more symmetrical, or to limit the exploitation of differential debt/equity treatment.** These are potentially important solutions to the wider non-tax threats to economic stability posed by excessive debt financing. **We are concerned, however, that in designing such measures, countries ensure that they do not erode corporate tax bases further or adversely affect the progressivity of the overall tax system; and that they are not excessively burdensome for low-income countries with relatively low tax takes and higher dependence on corporate tax than wealthier countries.**

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[17] R. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions,* IMF Staff Discussion Note, 3 May 2011, SDN/11/11.

[18] Recent IMF research confirms that thin cap rules can affect the capital structure of firms, but data availability necessarily confines this study to a 54-country sample of which only 6 are lower-middle-income countries, and none are low-income countries: J. Bouin, H. Huizinga, L. Laeven, G. Nicodème, *Thin Capitalization Rules and Multinational Firm Capital Structure* (IMF Working Paper WP/14/12, January 2014).

[19] Martin Hearson & Richard Brooks, *Calling Time: Why SABMiller should stop dodging taxes in Africa* (October 2010), p.28

[20] OECD Tax and Development Task Force, *Thin Capitalisation: a background paper for country tax administrations* (draft, August 2012), http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf

2.3.1 **ACE taxes:** Proposals for 'Allowance for Corporate Equity' (ACE) taxes, which provide a tax deduction for the notional cost of companies' equity capital as well as the cost of their debt, are gaining currency in some developed countries. They have already been tried in several European countries including Belgium, Italy, Latvia and Liechtenstein;[21] are proposed in forthcoming corporate tax changes in Switzerland;[22] and have been proposed by the UK Parliamentary Commission on Banking Standards for application to UK banks.[23] The likely reduction of corporate revenues produced by a full ACE tax, however – estimated by IMF research at some 15% of CIT revenue for a typical country[24] - may be unsustainable for lower-income countries that are generally more reliant on corporate income tax than developed countries (CIT constitutes some 18% of tax receipts in low and lower-middle income countries, compared to an average of 12.6% in high-income countries).[25] Progressivity problems may also be more acute in many low-income countries where the greater weight of foreign rather than domestic corporate investment means that the revenue shortfall from the introduction of an ACE tax is less likely to be made up by taxing the dividend income of shareholders, most of which will be resident outside the low-income country; and is thus more likely to be compensated for with higher taxes on labour and consumption.[26] Moreover, unless ACE taxes were introduced universally, their introduction in some countries seems likely to introduce new opportunities for tax arbitrage, and incentives for base erosion essentially through forms of 'thick capitalisation': for example, heavily funding an affiliate in an ACE jurisdiction with equity capital, generating ACE deductions there; while ensuring that the residence of the shareholding company is a non-ACE country in which dividend income remains untaxed.

2.3.2 **Anti-hybrid rules:** Specific rules preventing the exploitation of the mismatched tax treatment of debt and equity through 'hybrid financial instruments' are being considered in several jurisdictions, and within the OECD BEPS process. However, the most widespread proposals so far – those produced by the European Commission – currently focus on changes in the state of residence of the creditor, rather than the state whose tax base is

[21] In these cases not the actual equity cost i.e. dividends, but a fictitious interest cost of the adjusted equity of a company.
[22] Presentations to PwC Tax Forum, Geneva, 5 November 2013, http://www1.pwc.ch/fileadmin/steuerforum/downloads/tax_forum_geneva_2013_5112013.pdf
[23] UK House of Lords/House of Commons, *Changing Banking for Good: Report of the Parliamentary Commission on Banking Standards, Vol. II (HC 175-II)*, June 2013, paras. 1019-1026.
[24] R. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions,* IMF Staff Discussion Note, 3 May 2011, SDN/11/11.
[25] ActionAid calculations from data in USAID 'Collecting Taxes' database. 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 in this analysis.
[26] We acknowledge that modelling within the European Union has suggested that ACE taxes may be welfare-improving even if the tax burden on labour and consumption increases to compensate (R. de Mooij and M. Devereux, *Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms* (European Commission DG-TAXUD Working Paper No. 17, 2009)). But we are uncertain whether this would hold for low-income countries, given the differing composition of the tax base in most low-income countries discussed above, and their greater reliance upon a small number of large corporate taxpayers. The welfare effects of a reduction in the corporate tax burden under an ACE tax are also, of course, affected by the incidence of corporate income tax on labour vs. capital, which remains subject to considerable debate: R. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions,* IMF Staff Discussion Note, 3 May 2011, SDN/11/11, p. 18.

being eroded by the deduction of interest payments.[27] Such solutions may be more politically acceptable to wealthier countries by not shifting the balance of source and residence taxation, but it remains unclear whether jurisdictions strongly seeking to attract holding companies will necessarily have an incentive to reduce their exemptions of foreign equity income by inserting such an anti-hybrid rule.[28] To have a positive protective spillover on low-income countries, moreover, such anti-hybrid rules must extend to denying tax exemptions for profit-distributions that have been tax-deducted in all countries, not just the European Union.

2.4 In general, therefore, solutions focused on expanding the taxation at source of interest income would appear simpler; would allow those most affected by debt-related base erosion to act unilaterally rather than relying on action by creditor jurisdictions; and would have the additional benefit of generally ensuring that the balance of taxing rights is shifted towards lower-income countries which are generally importers of capital from wealthier countries. **Such solutions may include levying higher interest withholding taxes on payments into low-tax jurisdictions than into other jurisdictions; and the provision for greater taxation at source of interest income in bilateral tax treaties.**

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

4.1 Two trends since the 1960s have provided increased incentives for multinational businesses to shift taxable income and profits into low-tax jurisdictions, not only out of (often wealthier) headquarter jurisdictions, but also out of lower-income countries where they have operations:

- the trend towards more territorial tax regimes in countries which are major capital exporters and 'headquarter' jurisdictions – motivated by the greater pursuit of capital import neutrality in order to attract multinationals to headquarter there;
- coupled with declining tax rates in those 'headquarter jurisdictions' themselves, which might otherwise have deterred profit-shifting by lower foreign taxes on foreign income being 'topped up' to domestic rates on repatriation or via CFC regimes. [29]

4.2 In an era of rising fiscal vulnerabilities for many developing and emerging economies, and continued significant debt ratios in some developed economies,[30] the revenue sacrifice involved in moving large economies' tax bases towards a more territorial basis may make less sense both for

[27] European Commission, *Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States* (COM(2013)814 final), 25 November 2013, ec.europa.eu/smart-regulation/impact/ia.../com_2013_0814_en.pdf

[28] Some have already committed to such a change - the UK's participation exemption already includes an anti-hybrid rule, and the Netherlands has promised to restore one – but other key European 'holding company' jurisdictions are yet to commit.

[29] For a summary of these trends using data from the OECD tax database: PriceWaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD* (2 April 2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf

[30] IMF, *Fiscal Monitor* (October 2013), pp. 1-23.

those large economies and for lower-income countries where those large economies' multinationals operate.[31] Though it is difficult to precisely measure the disincentive to profit-shifting out of other countries provided by headquarter jurisdictions' tax charges on foreign income, it is suggested at least anecdotally by ActionAid's discussions with the tax staff of large multinationals, who have pointed to UK and South African Controlled Foreign Company (CFC) rules as counteracting profit-shifting from African and Asian subsidiaries into low-tax jurisdictions.[32] One would expect headquarter jurisdictions' reduction of taxation on foreign income to have the opposite effect.

4.3 **However, regardless of the balance which policymakers ultimately choose between capital import neutrality and capital export neutrality, *at a minimum* the international effects of such changes should be measured and included in policy decision-making.** We agree with the recommendation in the IMF/OECD/UN/World Bank report to the G20 in 2011 that "*it would be appropriate for G-20 countries to undertake "spillover analyses" of any proposed changes to their tax systems that may have a significant impact on the fiscal circumstances of developing countries…. including in their international tax regimes (in moving, for instance, from residence to territorial systems).*"[33] The international spillover effect of large economies' increasingly territorial tax systems is widely accepted by academics, economists and international institutions including the IMF.[34] Yet it is rarely presented explicitly by tax policymakers in major capital-exporting countries in their domestic debates about the international competitiveness of their tax systems. In 2011-2012, for instance, ActionAid pressed the UK government to undertake a spillover analysis of the international impact of proposed changes to the UK's Controlled Foreign Company (CFC) rules that essentially remove the UK CFC charge from profits shifted from other countries into UK multinationals' tax haven subsidiaries, and remove three-quarters of the CFC charge on tax haven subsidiaries' finance income, whether originating in the UK or in other countries.[35] These changes thereby removed the previous UK CFC regime's protection against profit-shifting for other countries, including low-income countries. Yet the UK government's response was that "*The UK's CFC rules are designed, and always have been, to protect the UK's tax take….[we] do not consider that a full impact assessment of CFC interim changes and the reforms to foreign branch taxation on developing countries' tax bases would*

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[31] In theory, of course, a country territorialising its tax base may hope that the measure may be revenue-neutral thanks to attracting more taxable business activities. Our observation of the UK's territorial tax roadmap in recent years suggests that this is difficult to achieve in practice: even after 'behavioural' considerations, the UK Treasury has projected net revenue falls from all recent territorialising measures.

[32] SABMiller letter to ActionAid, 11 November 2010, http://www.actionaid.org.uk/sites/default/files/doc_lib/sabmiller_right_of_reply_and_response1.pdf; Associated British Foods/Illovo Sugar Ltd letters to ActionAid, 28 October 2012, http://www.actionaid.org.uk/sites/default/files/publications/company_response.pdf. These responses do not indicate that CFC rules were successful in counteracting the tax benefits of profit shifting: in both cases the headquarter companies on which the CFC charges would be levied show extremely small tax charges, far smaller than would be expected from the application of CFC charges to the cross-border income that ActionAid identified; and in the case of ABF, the Zambian taxes primarily being avoided by the cross-border transactions in question were not profit taxes but withholding taxes (through treaty shopping), whose avoidance would obviously not be counteracted by CFC rules. Nonetheless the fact that both multinationals pointed to CFC rules as a counteracting factor indicates the perception that such rules do dis-incentivise some profit shifting out of non-headquarter countries.

[33] OECD/UN/IMF/World Bank, *Supporting the Development of More Effective Tax Systems: a report to the G-20 Development Working Group* (2011), p. 28, http://www.imf.org/external/np/g20/pdf/110311.pdf

[34] OECD/UN/IMF/World Bank, *Supporting the Development of More Effective Tax Systems: a report to the G-20 Development Working Group* (2011), pp. 27-28, http://www.imf.org/external/np/g20/pdf/110311.pdf; Peter Mullins, "Moving to Territoriality? Implications for the U.S. and the Rest of the World", *IMF Working Paper WP/06/161* (June 2006).

[35] ActionAid UK, *Collateral Damage* (March 2012), www.actionaid.org.uk/sites/default/files/doc_lib/collateral_damage.pdf

be appropriate…Such an assessment would not be relevant to the task of creating the most competitive corporate tax system in the G20 and encouraging more businesses to be based in the United Kingdom."[36]

4.4 By contrast, the members of the G8 and G20 in 2013 committed to "*ensure that…our own tax rules do not allow or encourage any multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions".*[37] Meaningfully implementing this commitment should require G8 and G20 members to assess the negative international spillover effects of their own tax regimes, particularly increased opportunities and incentives for profit-shifting; and to take mitigating steps in tax policy design. **To our knowledge no G8 or G20 member has yet done this for new or existing tax policy.**

4.5 It is difficult to predict *a priori* the likely international impact of ending U.S. deferral specifically, since it is obviously contingent on the interaction between deferral, CFC rules, and the U.S. corporate tax rate. For instance, if abolishing or seriously restricting deferral is accompanied by a very steep drop in the U.S. corporate tax rate to keep reform revenue-neutral, as the current U.S. administration has proposed, then the protection provided by U.S. worldwide taxation against profit-shifting by U.S.-headed multinationals out of non-US jurisdictions could actually be diminished if U.S. tax on the income of low-tax foreign affiliates is lower than the tax rates in low-income countries where U.S. multinationals have operations.[38] It is therefore possible that better international protection might be provided by maintaining deferral and comparable U.S. corporate tax rates to those in lower-income countries, while making U.S. CFC legislation more watertight, for instance through the fundamental reforms to the 'check the box' regime proposed by the 2013 Stop Tax Haven Abuse Act.[39] These are the kinds of empirical questions which should be answered through (dynamic) spillover analysis.

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?

5.1 Transfer pricing is a very large subject which goes well beyond the space and scope available in this submission.

5.2 In general, our discussions with developing country tax officials suggest that pricing inter-group transactions in developing countries based on comparables, as mandated by most of the OECD-approved transfer pricing methods, is often almost impossible; and taxpayers' prices,

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[36] Exchequer Secretary David Gauke, Hansard, Finance (No. 3) Bill Debate, 7 June 2011, c422.

[37] 2013 G8 Leaders' Communique, para. 24; 2013 G20 St Petersburg Declaration, para. 50.

[38] The U.S. administration has proposed cutting the statutory rate to 28% (25% for manufacturing), which is not dramatically below international average statutory or effective tax rates (J.G. Gravelle/Congressional Research Service, *International Corporate Tax Rate Comparisons and Policy Implications* (6 January 2014), https://www.fas.org/sgp/crs/misc/R41743.pdf). However, fully rescinding deferral might be expected to permit a deeper rate cut to keep the measure revenue-neutral. The Whitehouse, *The President's Budget: Fiscal Year 2015,* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/fact_sheets/building-a-21st-century-infrastructure.pdf

[39] Stop Tax Haven Abuse Act (S.1533), http://www.levin.senate.gov/download/?id=849F9977-BD68-48F1-A13F-37E4C438D36C

correspondingly, almost impossible for developing countries' revenue authorities to challenge. If unrelated-party comparables are notoriously hard to identify for company-specific services, goods and intellectual property in developed countries, then the much smaller numbers of companies in any sector in developing countries, and the widespread absence of publicly-available unconsolidated corporate accounts, means that unrelated comparables for developing-country inter-group transactions simply do not exist in the vast majority of cases. The Kenyan Revenue Authority, for example, has purchased a standard (and expensive) transfer-pricing comparables database, and has largely been unable to find any data of relevance in them.[40] The Rwandan Revenue Authority has previously declined to purchase such databases – ordinarily a standard part of tax authorities' toolkit – citing similar concerns.[41] The issue, however, is not with finding or centralising comparables in better datasets: in many cases it is likely that relevant comparables simply do not exist.

5.3 In the absence of more radical reforms to the international allocation of taxable income, we believe that there should be greater latitude for all countries, including developing countries, to apply simpler benchmarks, fixed margins or ceilings in transfer pricing. These include both the kinds of fixed-margin methods developed by Brazil and others (though it is important that such margins are updated regularly, and thus do not fall below what might be determined by comparables-based pricing); and also benchmarks and deductibility limits already applied by some developing countries to royalty payments, management and marketing fees to limit foreign exchange loss and incentivise technology transfer.[42]

5.4 Such methods would have two related benefits: they would increase the administrability of transfer pricing for less well-resourced tax authorities in smaller developing countries; and if applied more strictly to cross-border transactions with related parties in low-tax jurisdictions or enjoying low-tax preferential tax regimes, would help counteract base-erosion and profit-shifting.[43]

5.5 It is of course valid to seek to ensure that such fixed margins, benchmarks and deductibility ceilings do not increase double taxation. However, current arms-length transfer pricing methods themselves have the inherent capacity to generate large amounts of double taxation, and often in practice do so. The scarcity of comparables and consequent large inter-quartile variation between them – as much as 300% from top to bottom in many cases, according to a former director of the US Internal Revenue Service's Advance Pricing Agreement unit;[44] the subjective nature of arms-length pricing; and different outcomes of different 'arms-length' methods; all generate huge divergences in

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[40] Personal communication, March 2014; BEPS Monitoring Group, response to OECD BEPS report on *Transfer Pricing Comparability Data and Developing Countries*, March 2014.

[41] A. Waris, 'Rwanda: Understanding Transfer Pricing', *IBFD International Transfer Pricing Journal, Vol. 21, No. 1* (January/February 2014).

[42] E.g. the Central Bank of Nigeria's *Monetary, Credit, Trade and Foreign Exchange Policy Guidelines*, applied to Royalties and Technical Services Agreements approved by the National Office for Technology Acquisition and Promotion (NOTAP).

[43] For more comprehensive proposals to impose deductibility ceilings or limits specifically to possible base-eroding payments to foreign related parties in low-tax jurisdictions, see Michael C. Durst, 'Statutory Protection From Base Erosion for Developing Countries', *Tax Notes* (28 January 2013), pp. 495-8; or the European Parliament's proposals to limit the benefits of tax exemptions in the EC Interest-Royalties Directive where those interest or royalties are subject to low or no tax in the country of destination: Committee on Monetary and Economic Affairs, *Report on the proposal for a Council directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (recast) (COM(2011)0714 – C7-0516/2011 – 2011/0314(CNS))*, 12 July 2012, http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2012-0227&language=EN

[44] M.C. Durst, 'Analysis of a Formulary System for Dividing Income, Part III: Comparative Assessment of Formulary, Arm's Length Regimes', *Tax Management Transfer Pricing Report, Vol. 22 No. 9* (5 September 2013).

different tax authorities' assessment of the 'correct' pricing of a single cross-border transaction, as well as huge divergences from the taxpayer's own pricing. These have led to differences in assessments of tax liabilities in single U.S .transfer pricing disputes of up to $10bn or $11bn.[45] It is unclear whether fixed margins, benchmarks or deductibility ceilings would generate more or less double taxation than the current arms-length orthodoxy, but they would at least have the advantage of predictability and certainty for both taxpayer and tax authority.[46] There seems little reason why the resulting (predictable) double taxation could not be relieved, as at present, through existing mechanisms including Mutual Agreement Procedures, potentially at considerably less cost than with disputes involving less predictable pricing methods.

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

6.1 **Current methods for allocating taxable income and profits between countries are not working well for many developing countries, and consideration of proposals for fundamental changes is welcome. Such changes - such as the replacement of separate-entity taxation with unitary taxation, and the expansion of formulary methods to apportion taxable income internationally - should certainly not be ruled out without systematic analysis of their likely impacts.** In the case of unitary taxation systems, much research has focused either on its application within high-income countries whose federal tax systems operate unitary or quasi-unitary systems (USA, Canada, Switzerland), or on prospective international application within the European Union through the Common Corporate Consolidated Tax Base. Analysis of different unitary tax systems' impacts on developing countries in the event of wider international application is still at an early stage; we believe that forthcoming publications by the International Centre for Tax and Development's recently concluded programme of research on 'Unitary Taxation of Transnational Corporations with special reference to Developing Countries', in whose research meetings ActionAid has participated, will advance the knowledge base significantly.[47]

6.2 **Following the principle of considering inter-nation equity in tax policymaking, designers of any fundamental reform to the international allocation of the corporate tax base – whether based on separate-entity or unitary taxation – should of course ensure that it does not excessively disadvantage the tax base or tax revenues of low-income countries; and that such impacts can be mitigated.** For example, U.S. state experience under formulary apportionment shows a migration towards exclusive sales-based taxation in many states' allocation formulae, presumably under tax-competitive pressure to reduce taxation on incoming investment (assets) or on job creation (payroll/headcount).[48] Regardless of whether similar shifts would be driven by tax competition under

[45] M.C. Durst, 'Analysis of a Formulary System for Dividing Income, Part III: Comparative Assessment of Formulary, Arm's Length Regimes', *Tax Management Transfer Pricing Report, Vol. 22 No. 9* (5 September 2013).
[46] M.C. Durst, op. cit.
[47] Other important contributions include M. Keen & K. Konrad, 'International Tax Competition and Coordination', *Max Planck Institute for Tax Law and Public Finance, Working Paper 2012-06* (July 2012), www.tax.mpg.de/RePEc/mpi/wpaper/Tax-MPG-RPS-2012-06.pdf
[48] K.A. Clausing, *Lessons for International Tax Reform from the U.S. State Experience under Formulary Apportionment* (24 January 2014), http://ssrn.com/abstract=2359724

a multi-formula unitary tax system, or by the greater political weight of business interests and large consumer economies in an international negotiation over the choice of a universal set of formulae, clearly a unitary tax system with sales-heavy allocation formulae could risk disadvantaging the tax bases of some smaller developing countries that are reliant upon export-oriented primary production (extractives, agribusiness).[49]

6.3 Similar questions of inter-nation equity should also influence the design of allocation keys if residual profit-split methods are to be used more widely in separate-entity transfer pricing – as seems likely at least for returns to intangibles.[50]

6.4 This is not, however, to argue that such allocation keys or apportionment formulae would necessarily be undesirable. The important comparison should not be simply whether a given formula or allocation key would allocate greater profits to wealthier countries; but whether the equity of this allocation would be better or worse than under current separate-entity and transfer pricing methods. **This is why a baseline measurement of the 'international tax-base progressivity' of the current international corporate tax base is an important task, consonant with the recommendation for a baseline spillover study made by international institutions to the G20 Development Working Group in 2011.[51]**

6.5 Such a baseline measurement would presumably begin by establishing the current distribution of the taxable base across different countries: probably using corporate accounting profits as a proxy, in the absence of data about taxable profits from companies' tax returns; and perhaps using international financial accounting datasets,[52] plus country-by-country reporting datasets as they become more prevalent following European and OECD initiatives, which might start to fill in data gaps for developing countries. A static analysis would then examine how this distribution would be altered by a given method for allocating the tax base, or taxing rights over that base, between different countries.[53] Dynamic modelling might predict how changes in economic activity in response to the tax rule changes would also change the distribution of the tax base.

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

7.1 **We believe international tax initiatives should focus not only on particular jurisdictions, but on the nature and impact of tax regimes wherever they are located.** Certainly harmful tax regimes may

[49] The larger question of whether sales-heavy unitary taxation would disadvantage even those smaller developing countries running trade deficits, is less clear. It is discussed further here: http://treehugginghoolah.blogspot.co.uk/2013/12/rethinking-corporate-tax.html

[50] OECD, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (July 2013), http://www.oecd.org/ctp/transfer-pricing/revised-discussion-draft-intangibles.pdf

[51] IMF/OECD/UN/World Bank, *Supporting the Development of More Effective Tax Systems: a report to the G-20 Development Working Group* (2011), p. 28, http://www.imf.org/external/np/g20/pdf/110311.pdf

[52] Examples include Bureau van Dijk's 'Orbis' dataset.

[53] Some work by the ICTD's unitary taxation programme (see para. 6.1) has been developing analyses of the international distribution of the corporate tax base of this kind.

be more prevalent in some jurisdictions traditionally regarded as tax havens.[54] Nonetheless ActionAid's research has identified harm to developing countries from tax regimes introduced in a number of large developed economies: including the UK's CFC Finance Company exemption, incentivising excessive debt-financing of UK-headed multinationals' subsidiaries elsewhere;[55] Dutch IP amortization rules, encouraging base erosion in sub-Saharan African countries through large royalty payments for African IP migrated to the Netherlands;[56] and the tax treatment of European cooperatives, allowing the avoidance of taxes on dividends paid by developing country subsidiaries.[57] Likewise the OECD's Forum on Harmful Tax Practices, and the EU's Code of Conduct Group on Business Taxation, have identified harmful tax regimes in both Member State countries and finance-dominated dependent territories.

7.2 Current international efforts to align profits with economic activity, and to counter 'harmful tax regimes', are focused strongly on boosting substance requirements for entities to qualify for tax benefits in given jurisdictions.[58] Though useful, there are two limitations to this approach:

7.2.1 Substance requirements regarding personnel, the physical location of 'key functions', office space and tangible assets,[59] may not have much application to investment and financing activities that may nonetheless heavily erode other countries' tax bases when located in low-tax jurisdictions, but do not typically have extensive physical operations associated with them, and regarding which it can be legitimately argued that it is the provision of capital and the bearing of risk, rather than physically performed activities, which generates a substantial proportion of returns. In any case, current international tax reforms continue to emphasise to some degree the attribution of income to entities which have legal ownership of (particularly intangible) assets, and which provide capital or bear risk, rather than more radical reattribution of income and profits to the entities physically performing key functions.[60] This residual attachment in international tax standards to form over function seems likely to limit incentives for some jurisdictions to boost their substance requirements dramatically.

7.2.2 **Negative spillovers on low-income countries may be just as powerful when mobile, high-value economic functions within multinational groups are genuinely, physically moved to low-tax jurisdictions or to countries where they enjoy preferential tax regimes.** A multinational enterprise that physically concentrates management or supply-chain

[54] For example, the list of 50 jurisdictions compiled by the U.S. Government Accountability Office as either having been listed by the OECD in 2007 as an 'uncooperative jurisdiction' or one in need of reform for tax transparency; listed as a tax haven by the US National Bureau of Economic Research; or included in a list of problematic jurisdictions compiled in a US district court ruling: U.S. Government Accountability Office, *International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy jurisdictions* (December 2008), p. 12, http://1.usa.gov/nZUjYR

[55] ActionAid UK, *Collateral Damage* (March 2012), www.actionaid.org.uk/sites/default/files/doc_lib/collateral_damage.pdf

[56] Martin Hearson & Richard Brooks, *Calling Time: Why SABMiller should stop dodging taxes in Africa* (October 2010), pp. 23-24.

[57] Mike Lewis, *Sweet Nothings: The Human Cost of a British Sugar Giant Avoiding Taxes in Southern Africa* (London: ActionAid UK, 2013), pp. 25-26, http://www.actionaid.org.uk/sites/default/files/doc_lib/sweet_nothings.pdf.

[58] OECD, *Action Plan on Base Erosion and Profit-Shifting*, July 2013, Action 5, pp. 17-18, www.oecd.org/ctp/BEPSActionPlan.pdf

[59] OECD, *Action Plan on Base Erosion and Profit-Shifting*, July 2013, p.13, www.oecd.org/ctp/BEPSActionPlan.pdf

[60] Compare, for instance, the initial (2012) and revised (2013) drafts of the OECD's *Discussion Draft on Transfer Pricing Aspects of Intangibles*.

procurement staff in Luxembourg or Switzerland, or R&D activities within 'innovation box' vehicles in Belgium or the UK, may erode the tax bases of developing countries just as much as a multinational enterprise that intangibly transfers intellectual property to Bermuda or internal financing to Mauritius. Indeed, such 'genuine' tax-efficient supply-chain management may also have the additional negative impact of genuinely depriving lower-income economies of higher-value economic activities, from high-paid management staff to backward-linking research and development, thereby impeding the ability of their economies to move up global supply chains.

7.3 **Harmful tax regimes should thus be identified on the basis of measurements of their fiscal and wider economic harm,** particularly to low-income countries, as much as on the basis of a typology or criteria relating to the nature of the tax regime (preferential, 'ring-fenced', not requiring substance, and so on).[61]

7.4 In the absence of more fundamental reforms to separate-entity taxation, comprehensive defences against shifting income into entities taking advantage of harmful tax regimes need to encompass measures at the source of that income, in the jurisdiction of the harmful tax regime, and in the residence/headquarter state of the multinational enterprise. These encompass measures discussed above which, we have argued, may also tend to shift the allocation of the tax base towards lower-income countries, and may thus have wider benefit for inter-nation equity.

7.4.1 **'Source'-based measures** may include greater latitude for both developed and developing countries to impose higher taxes, including withholding taxes, on cross-border transactions enjoying harmful tax regimes in the other state; limiting the tax-deductibility of such transactions; or setting ceilings on their pricing *[see question 5 above]*. Such measures have been startlingly effective at undermining financial secrecy in many jurisdictions, as shown by the remarkable impetus given to financial account information exchange by the USA's FATCA initiative, proposing a 30% withholding tax on cross-border payments into non-cooperating jurisdictions and financial institutions; it is likely that disadvantageous tax measures, if adopted by powerful developed economies, would also have an impact on the sustainability of harmful tax regimes if directed at them.

7.4.2 **'Residence'-based measures** that could protect lower-income countries may include developed capital-exporting economies restricting the territoriality of their corporate tax regimes in the case of income enjoying harmful tax regimes in other countries, including through CFC regimes that apply 'headquarter' taxes to low-taxed income irrespective of where that income has been shifted from (see question 4 above); and waiving participation exemptions in instances where profit distributions have been subject to low- or no-tax in the country of source.

[61] For a proposal for such a definition as applied to corporate tax planning rather than national tax regimes, see David Quentin's suggestion of a development-specific definition of abusive tax behaviour: International Bar Association, *Tax Abuses, Poverty and Human Rights: A report of the International Bar Association's Human Rights Institute Task Force on Illicit Financial Flows, Poverty and Human Rights* (October 2013), pp.208-209.

7.4.3 **Collective measures to *directly* address harmful tax regimes** are at a nascent stage in many parts of the world, and have often lacked political force or commitment.[62] Definitional questions and issues of tax sovereignty remain. However, it is salutary that developing country groupings have also begun to initiate nascent collective efforts to constrain harmful tax competition. These include the draft Code of Conduct Against Harmful Tax Competition in the East African Community (EAC), which a coalition of East African civil society organisations have recently urged their governments to sign and ratify;[63] and the fiscal integration measures of the West African Economic and Monetary Union (WAEMU) Treaty and Directives, though it appears in practice that these may be being undermined by harmful tax incentives granted outside the tax codes of WAEMU member states. In light of the huge revenue impacts of 'horizontal' tax competition between developing countries *[see below question 8]*, these initiatives deserve greater analysis and support.

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'?

8.1 As with tax treaties *[question 1]*: regardless of whether or not it is possible to say that measures intended to make a country's tax system more attractive to mobile capital can never bring economic benefits, ActionAid's experience in both developed and developing countries is that, in many specific instances, policymakers' belief in this principle is considerably stronger than evidence either of the tax-responsiveness of the mobility of capital, or of the economic benefits of a given tax-competitive measure:

8.2.1 In Sierra Leone, recent research commissioned by an alliance of Sierra Leonean civil society organisations supported by ActionAid found that - according to figures from the National Revenue Authority and a mining tax model developed by the IMF for the Sierra Leonean government – VAT, customs duty and corporate income tax exemptions granted to just six multinationally-owned companies (4 mining companies, a biofuels producer and a cement manufacturer) had led to foregone revenues of at least Le 840.1bn ($199m) a year from 2010 to 2012 – over 7% of Sierra Leone's GDP, and 13.8% of GDP in 2011.[64] Such an immense revenue cost in one of the world's poorest countries, which currently raises just 10.9% of its GDP from taxes, seems difficult to justify in any circumstances, but particularly not in awarding tax subsidies to mining companies, amongst the least mobile sectors of multinational capital, whose location decisions are primarily dictated by the physical presence of minerals. If ever there was an argument against a one-size-fits-all fiscal policy wedded to tax competition to attract FDI, this case is surely it.

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[62] J.C. Sharman, "Norms, Coercion and Contracting in the Struggle against 'Harmful' Tax Competition," *Australian Journal of International Affairs* 60 (March 2006), pp. 143-169; J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation* (Ithaca: New York, 2006).

[63] Open Letter to the Finance Ministers of the East African Community, http://www.actionaid.org/kenya/open-letter-ministers-finance-east-african-community

[64] Sierra Leone Budget Advocacy Network (BAN) & National Advocacy Coalition on Extractives (NACE), *Losing Out: Sierra Leone's massive revenue losses from tax incentives* (February 2014).

8.2.2 While seeking the "most competitive corporate tax regime in the G20" by shrinking the scope of the UK's CFC rules to attract multinational headquarters to the UK – a shrinkage which also removed the CFC rules' indirect protection for other countries - the UK Treasury has been unable to project or quantify likely economic benefits in terms of job creation, growth or the relocation of substantial economic activity as a result of attracting headquarter companies' tax residence (though they have projected an annual UK revenue loss of nearly £1bn annually by 2015/16).[65] Anecdotal examples suggest that this tax-competitive measure may incentivise headquarters relocation *without* relocating substantial economic functions: when, for example, a major international insurance broker announced their HQ relocation from Chicago to London in anticipation of the UK's CFC reforms, the company's board told journalists and investors that the company had no plans to dramatically increase their UK headcount, was moving "less than 20" senior staff, and was in fact growing its U.S. job base by 1000.[66] Another multinational firm that publicly cited the previous UK CFC regime as a reason for 'fleeing' its UK headquarters was reportedly found to have moved just eight staff to its new Irish corporate headquarters, according to UK journalists who visited, the remainder staying in London.[67]

8.3 These examples are anecdotal and do not, of course, indicate that social and economic benefits can never be generated by reducing tax on mobile capital in any circumstances;[68] but simply that there is often little or no sound evidence regarding particular measures or situations on which tax-competitive policymaking is based.

8.4 In identifying harmful tax competitive measures, we find it analytically useful to distinguish between two kinds of tax-competitive pressures:

8.4.1 Direct 'horizontal' tax competition: as in the examples above, countries seeking to poach businesses or economic activity from other countries in a similar economic position in global value chains. This has formed the focus of EU, EAC, WAEMU and OECD efforts against harmful tax competition *[question 7].*

8.4.2 Indirect 'vertical' pressure on a country's tax rates or tax base from the tax treatment in other countries of cross-border capital or income: particularly those generated by moves in major capital-exporting countries, including tax havens and major developed economies, towards more territorial tax systems *[question 4]*. Such measures essentially affect the sensitivity of a multinational enterprise's effective tax rate to changes in the tax rate in a given country where it operates. **It is notable that there has as yet been no systematic international effort to measure or constrain such indirect pressures.**

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[65] ActionAid UK, *Collateral Damage* (March 2012), www.actionaid.org.uk/sites/default/files/doc_lib/collateral_damage.pdf

[66] Aon filings with US Securities and Exchange Commission (SEC), January 2012; Jamie Dunkley, 'Aon move to London in boost to UK economy', *Daily Telegraph,* 13 January 2012; 'Aon To Move Corporate Headquarters to London', *Aon Corporation Press Release*, 13 January 2012.

[67] 'Low tax, low cost flight to Dublin', *Guardian (UK),*10 February 2009.

[68] Multivariate analysis from developed countries including the U.S., however, do suggest that economic benefits from tax competition accrues substantially the 'first movers', and that its benefits decrease for the rest: K.A. Clausing, *Lessons for International Tax Reform from the U.S. State Experience under Formulary Apportionment* (24 January 2014), http://ssrn.com/abstract=2359724; for a longitudinal study on a U.S. single state, M.M. Rubin & D.G. Boyd, *New York State Business Tax Credits: Analysis and Evaluation* (November 2013), http://www.capitalnewyork.com/sites/default/files/131115__Incentive_Study_Final_0.pdf.

8.5 As discussed above *[paras. 7.1, 8.2]*, both direct 'horizontal' tax competition and indirect 'vertical' pressure can cause significant harm to developing countries' tax bases, and it is difficult to compare them quantitatively. Since the second type, however, is primarily generated by wealthier capital-exporting economies while affecting all countries, including lower-income countries, its mitigation is an issue of inter-nation equity. We believe that EU, OECD and other international efforts to define and mitigate harmful tax regimes should include these forms of pressure as well as 'horizontal' tax competition. While pursuing capital import neutrality is of course a sovereign tax policy choice, and might not in itself be labelled harmful, nonetheless measures in pursuit of greater capital import neutrality which indirectly facilitate double-non-taxation (like overly broad participation exemptions that exempt foreign income from tax even when it has been untaxed or tax-deducted in the source country) or which reward profit-shifting to low-tax jurisdictions (like the UK's revised CFC rules) might be identified as harmful, and counteracted.