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PATCHING UP A BROKEN TAX SYSTEM

Why BEPS is not the solution to poor countries' tax problems

Executive summary

ActionAid believes that the OECD's proposed reforms to the international tax system (BEPS) fail to tackle tax avoidance by multinationals, exclude developing nations and will fail to deliver for the poorest people in the world.

The IMF estimates that developing countries lose about than US$200billion annually due to tax avoidance.

During the 2013 UK presidency of the G8, David Cameron used the Lough Erne summit in Northern Ireland to commit to reform of the international tax system. That commitment led to the Base Erosion and Profit Shifting (BEPS) process, which will publish its final recommendations on 5 October 2015.

The recommendations have been widely trailed. ActionAid believes they fall far short of what is necessary to help developing countries collect their fair share of tax from corporations:

- **BEPS is not a global process.** The G8, G20 and OECD countries have largely excluded poor countries and unilaterally negotiated and agreed a hugely complicated set of recommendations for how international tax rules should change.
- **BEPS will not end tax avoidance.** The proposals amount to tinkering at the edges of the current tax system; will be difficult for poor countries to implement and will not stop the industrial-scale tax avoidance which undermines the finances and public services of developing countries.
- **BEPS does not address the distribution of taxing rights between countries.** The global network of tax treaties between countries often impedes poor countries from taxing profits generated in their territory. BEPS does not address this problem at all.
- **BEPS does not end the race to the bottom as countries undercut each other on tax rates.** This means that wasteful tax breaks and harmful tax giveaways will continue to undermine tax revenues globally.

To fix the global tax system, solutions beyond BEPS are needed. The OECD, a club of rich countries, cannot come up with those solutions. A more representative global body to decide on tax rules on tax is needed - a well-resourced and authoritative UN Tax Body should therefore be created with universal membership. Developing countries should review the way they grant tax breaks and negotiate tax treaties to ensure they don't miss out on vital tax revenue. And if we are serious about ensuring that poor countries can raise tax revenue to fund their own development, then we need to address harmful tax competition. And that is one fight the BEPS process has no intentions of fighting.

What is BEPS?

In 2013, following a public outcry over tax dodging, the G8 meeting in Lough Erne committed to reform the international tax system in a welcome recognition that the current system is broken.[1] The G8 countries promised that such reforms would benefit developing countries. The G20 declaration in St Petersburg 2013 also stated specifically that "developing countries should be able to reap the benefits of a more transparent international tax system".[2]

As a result of these commitments, the G8 and G20 mandated a process to address the tax avoidance techniques of base erosion and profit-shifting. The result was the BEPS process which is led by the Organisation for Economic Cooperation and Development (OECD), a 34-member body dominated by some of the world's richest countries.

After two years of work, we will shortly see the publication of the BEPS outcomes. Some of these measures could potentially be useful to developing countries, but are so complex for these countries to apply that their practical benefits are open to question. Other measures are irrelevant to developing countries. Some are potentially harmful.

According to estimates by International Monetary Fund (IMF) staff, developing countries lose about US$200 billion annually due to tax avoidance.[3] Recent figures from the United Nations Conference on Trade and Development (UNCTAD) show that the amount of tax avoided by companies in developing countries may be equal to nearly half of the amount of corporate income tax revenue collected.[4]

And these figures do not take into account the additional costs of countries giving away unnecessary tax breaks to investors, and of countries being unable to tax some corporate income because of an unfair division of taxing rights between the countries where companies are resident and the countries where they make their profits.

An effective reform process of the international system should have had developing countries involved as equal partners from the start of negotiations and put developing country interests at its heart. Unfortunately BEPS has done neither, as this briefing will explain.

BEPS is not a global process

It is clear that the current international tax system is not working for poorer countries. It deprives them of funds needed not only for immediate investments such as in good-quality education and healthcare, but also for longer term development plans that will sustainably lift people out of poverty.

Developing countries could therefore benefit greatly from serious reforms to international tax norms and standards. It is therefore a shame that there is no such global reform process of the international tax system underway with developing countries and the tax problems they face as its focus.

Instead, through the BEPS process, G20 and OECD countries have unilaterally negotiated and agreed among themselves a set of recommendations for how international tax rules should change. Developing countries have in various ways been invited to comment on

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[1] See https://www.gov.uk/government/publications/g8-lough-erne-declaration/g8-lough-erne-declaration-html-version for further details.
[2] https://www.g20.org/sites/default/files/g20_resources/library/Saint_Petersburg_Declaration_ENG_0.pdf
[3] https://www.imf.org/external/np/pp/eng/2014/050914.pdf
[4] UNCTAD. World Investment Report 2015. June 2015, Estimates of CIT paid and avoided on p.185 and p. 200 respectively. See http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

proposals, and some have even been invited to the negotiating table to discuss reforms; however, they have not been equal negotiating partners, and have only been consulted towards the later stages of the process.

While these attempts to open up dialogue with developing countries regarding international tax rules are welcome, they do not make the BEPS process a truly global process or ensure that it has developing countries' interests at heart. This has consequences for the content of the BEPS recommendations, which largely reflect the concerns and capacities of developed countries rather than problems facing developing countries.

BEPS doesn't end global tax avoidance

Tax experts and the OECD itself agree that the principles on which the current international tax system was designed are based on what the world and companies looked like around a century ago. Today, more than a third of all international trade is intra-company trade – that is, different subsidiaries within a multinational corporation (MNC) buying goods and services from each other.[5] This means that money can easily be shifted around within big companies, often using subsidiaries in tax havens, so that they are taxed as little as possible.

One way of dealing with this, proposed by some experts,[6] would be to tax MNCs as single global companies. The BEPS process, however, continues to base its recommendations on the fiction that each subsidiary of a big company can be treated as a separate entity trading with other subsidiaries in the same way that independent companies would trade with each other in an open market. Much of the complexity and shortcomings of the BEPS recommendations arise from an attempt to maintain this fiction while trying to curb its negative effects.

In its attempts to do so, the BEPS process comes up short in many respects:

- **Country-by-country reporting (Action 13) -** Its proposals on requiring MNCs to report their income, tax payments and other key data to tax authorities, for each country where they do business, are a step in the right direction. But the reports won't be made public, which defeats the main object of allowing independent scrutiny of companies' tax affairs. And they will only be made available to national tax authorities through formal mechanisms which may end up excluding tax authorities in many developing countries.[7] Moreover, these proposals will only apply to companies with an annual turnover of €750million or more, which will leave out many smaller companies operating across borders.
- **Controlled Foreign Company (CFC rules) (Action 3) –** CFC rules are designed to deter companies from shifting profits into tax havens, but the BEPS proposals for reforming them are very weak. They propose a low threshold for defining what CFC income is and, crucially, they do not insist that developed countries' CFC rules should cover income shifted into tax havens from third countries, which are often developing countries. The OECD recognises that CFC rules which provide such cover would help to protect the tax bases of developing countries, but stops short of recommending that developed countries should adopt them.
- **Harmful tax practices (Action 5)** - In recent years wasteful tax competition through tax incentives, such as tax breaks for intellectual property (IP) has become increasingly common. The BEPS recommendations on "harmful tax regimes" could have been an opportunity to address this problem but they only require a company to prove that the economic activity for which it is seeking a tax break actually took place in that jurisdiction. The recommendations do nothing to challenge the idea that

[5] P. 5 http://www.oecd-ilibrary.org/docserver/download/5kg9p39lrwnn.pdf?expires=1442334453&id=id&accname=guest&checksum=5BD951C020CE37A515A695EC7346D51F
[6] See http://www.icrict.org/wp-content/uploads/2015/06/ICRICT_Com-Rec-Report_ENG_v1.4.pdf
[7] See http://uncounted.org/2015/09/14/oecd-country-by-country-reporting-only-for-the-strong/

governments should be able to undercut each other by offering special tax regimes to companies, and may even entrench it.

These are just a few examples of where the BEPS process comes up short in addressing the tax problems most countries face. An additional problem is the level of discretion and flexibility built into many of the recommendations.[8] While flexibility may be a good thing up to a point, the wide room for interpretation and inevitably patchy implementation of the BEPS recommendations across numerous countries has led the OECD to also propose a stronger dispute resolution mechanism. This risks leading to increased litigation costs for all countries – a particular danger for poor countries with limited resources.

BEPS doesn't end tax avoidance in developing countries

Malawi loses US$27.5m from just one company's tax planning

Over a period of six years (2009 – 2014) – Paladin, an Australian mining company operating in Malawi – managed to avoid paying over US$27.5m in withholding taxes through treaty shopping. Treaty shopping is the common practice of companies routing investments through third countries purely in order to take advantage of tax breaks enshrined in their treatiesPaladin did this by routing intra-company interest and management fees payments from the Malawian subsidiary to the Australian parent company via the Netherlands

The Malawi-Netherlands tax treaty in force at the time did not allow Malawi to apply withholding taxes on interest payments and management fees paid from Malawi to the Netherlands. Had the Malawian subsidiary sent the money straight to the Australian parent without the money passing through the Dutch subsidiary – which had no employees and effectively just acted as a conduit for the payments – Malawi would have been able to apply a statutory 15% withholding tax to those payments because Malawi and Australia do not have a tax treaty.

In total, Malawi lost US$27.52m in withholding tax from Paladin's treaty shopping. Paladin had also been given a generous tax break which lowered its tax contributions by at least a further US$15.64m over the six year period. In total, the Malawi government lost out at least US$43.16m from Paladin's tax affairs. This could have paid for:

- 431,000 annual HIV/AIDS treatments; or
- 17,000 annual nurses salaries; or
- 8,500 annual doctors' salaries; or
- 39,000 annual teachers salaries.

For full details of the Paladin case study, see 'An Extractive Affair'[9]

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[8] For example, intra-group debt, which often far exceeds the firm's overall borrowing from third parties, is a major cause of base erosion and profit shifting. The draft BEPS recommendations propose an interest deduction cap within a suggested band, with the option of using apportioned consolidated interest costs if they are higher. This means this recommendation may be implemented in very different ways in different jurisdictions.

[9] http://www.actionaid.org/sites/files/actionaid/malawi_tax_report_updated_table_16_june.pdf

Like Malawi, many developing countries see multinational companies move money out of their countries untaxed because the current international tax regime makes it perfectly legal for companies to do so. In fact, a 2015 study released by the United Nation Conference on Trade and Development (UNCTAD) estimates that companies owned from tax havens and conduit companies avoid US$100 billion in taxes each year through shifting profits out of developing countries.[10] ActionAid's analysis of these results finds that for every US dollar of tax multinationals pay in developing countries, they avoid about 45 US cents.

Some of the challenges faced by developing counties – such as transfer mispricing, excessive interest payments on intracompany loans and hybrid mismatches (the exploitation of certain differences between countries' tax rules) are addressed by the BEPS project. However, the draft recommendations are:

- Resource-intensive (such as the transfer pricing recommendations)
- Filled with exemptions that severely weaken their effectiveness (such as the recommendations on intra-company loans)
- Not designed with developing countries in mind (such as the minor changes suggested to anti-tax haven legislation or CFC rules)

All of this means that it will be hard for poor countries to implement the BEPS recommendations, and even if they do, they are unlikely to collect significantly more tax revenue as a result.

BEPS does not address the imbalance in taxing rights between rich and poor countries

The BEPS process does not attempt to re-balance in any meaningful way the balance of taxing rights between the source or host countries (where economic activity takes place) and residence or home countries (where the parent company that owns the subsidiary in the source country is located).

Taxing rights are usually outlined in double taxation treaties between jurisdictions. Tax treaties usually allocate to the source country the right to tax the 'active' or business income earned by a foreign investor in that country, provided that the investor's activities are of a type and duration which is sufficient to create a taxable presence or 'permanent establishment' (PE). The right to tax 'passive' or investment income is allocated to the residence country.

However, by ensuring, for example, that lucrative sales in that country are booked in a tax haven instead, multinationals can avoid having a permanent establishment in a country and avoid paying taxes there. However, there are a multitude of ways of (quite legally) turning active income into passive income (for example through dividend payments), as well as of shifting profits out of the source country.

Source countries still get to tax some of this shifted income through 'withholding taxes'. But these taxes are often severely limited by tax treaties; this is the main way that treaties can be balanced against developing countries.

In order to retain taxing rights it is also important for countries to have rules defining whether a company's activities on their territory is taxable; this is known as 'permanent establishment'. Treaties can also lift the bar for when permanent establishment can be claimed.

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[10] See http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

BEPS doesn't end tax competition and harmful tax incentives

Harmful tax incentives are a problem affecting tax revenue in many developing countries. They are often granted following heavy corporate lobbying and on the assumption that tax giveaways encourage investment, despite skepticism from many experts about whether they are really necessary. For example, World Bank research in 2013 showed that 93% of foreign investors in East Africa said they would have invested even if tax incentives had not have been offered.[11] ActionAid figures from 2013 show that developing countries lose around US$138bn per year in corporate income tax exemptions.[12]

The BEPS process does not deal with tax incentives in poorer countries, and nor should it. The G20 recognises the problem – its Development Working Group wrote a background paper on this issue in 2015 and has opened a consultation on how to address tax incentives in poor countries.[13] But the G20 is not the appropriate institution to make policy for the world's poorest countries, which are not members of it

Apart from the immediate losses of tax revenue, the practice of tax incentives also runs a risk of encouraging a race to the bottom, where countries undercut each other's effective tax rates in order to attract investment, with all countries involved losing out on tax revenue as a result. As the IMF's Managing Director Christine Lagarde has pointed out: "By definition, a race to the bottom leaves everybody at the bottom". [14]

This highlights the problem that BEPS definitely doesn't solve – tax competition. While BEPS might in some cases broaden the tax base in some countries, it doesn't address the race to the bottom for headline corporate income tax rates and the big tax giveaways through ever larger tax exemptions; and it doesn't address the proliferation of special tax regimes which erode tax payments globally, including in developing countries. In fact it is possible that BEPS could even lead to more tax competition. as countries which can no longer offer the kinds of artificial schemes targeted by BEPS look for other ways to cut their tax rates.

New geographical special tax regimes are also cropping up in rich countries. In 2015, Portugal introduced a special tax regime for the Madeira International Business Centre (MIBC), which will give qualifying companies a 5% corporate income tax and a range of exemptions on other taxes.[15] Spain's Canary Islands have recently expanded a similar scheme,[16] and despite its posturing on tax avoidance, the European Commission has approved both regimes. These schemes are open to be used to channel income from developing countries – primarily Africa due to their geographical location – to richer countries, and they will also put further downwards pressure on tax rates elsewhere as other countries and regions seek to compete for mobile capital. Again, BEPS does not address this problem

If not BEPS – then what?

While it is welcome that the G8 and G20 have recognized that base erosion and profit shifting is a problem, the process devised to solve the problem is not delivering. The BEPS process is ***not*** a global process. It does ***not*** solve developing countries' tax problems in taxing

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[11] Edward Mwachinga, *Results of investor motivation survey conducted in the EAC*, World Bank, presentation given 12.02.13 in Lusaka. http://bit.ly/14B0AqE
[12] p. 8, http://www.actionaid.org/sites/files/actionaid/give_us_a_break_-_how_big_companies_are_getting_tax_free_deals_-_aug_2013.pdf
[13] See http://www.imf.org/external/np/exr/consult/2015/taxincentives/
[14] https://www.imf.org/external/np/speeches/2014/062714.htm
[15] http://www.pwc.com/en_US/us/tax-services/publications/insights/assets/pwc-tax-insights-from-its-portugal-approves-new-regime-7815pdf.pdf
[16] http://www.pwc.com/en_US/us/tax-services/publications/insights/assets/pwc-spain-approves-improved-special-tax-regime-canary-islandsapril29.pdf

multinational companies. If developing countries want to address their tax problems, other solutions are needed. These include:

More representative global decision-making

All developing countries must be able to discuss and decide on international tax rules on an equal footing with all other countries; something the OECD and G20 will never be able to facilitate because their members are groups of bigger and wealthier countries. The shortcomings of BEPS cannot be addressed by the OECD simply inviting more countries to join its discussions, because the parameters and outcomes of those discussions will always end up being shaped by the OECD's powerful member countries and by its own worldview as a rich-country club.

An alternative space for discussion, debate and negotiation must be created; one which gives all countries an equal say and which addresses the issues of most importance to developing countries. At present the UN is the most legitimate place for such negotiations about global tax rules to take place; a well-resourced and authoritative intergovernmental **UN Tax Body** should therefore be created with universal membership.

Unilateral developing country actions

While multilateral solutions are preferred to international tax problems, there are actions poorer countries can take in the absence of a global tax body. National and regional frameworks on how to grant ***tax incentives*** can be developed that increase transparency regarding the decision-making process and which guarantee that only tax breaks that actually increase overall tax revenue are granted.

National frameworks for how to negotiate ***tax treaties*** should also be agreed on, to ensure that no taxing rights are handed away unnecessarily, and that tax revenue is maximized. This should also include a review and where appropriate, a renegotiation of existing tax treaties.

Developing countries can also implement ***unilateral actions*** to protect their tax bases, such as disallowing excessive tax deductions by corporations and requiring them to use simpler methods of transfer pricing.

Stopping harmful tax competition and harmful tax practices

Countries – rich and poor alike – need to stop engaging in harmful tax practices and tax competition. A race to the bottom only leaves everyone at the bottom. It is counterproductive in the long run to try to close tax loopholes with one hand, while the other one is cutting corporate tax rates and creating special IP regimes and special geographical zones which undercut other countries. This will just decrease overall tax revenue.

If we are serious about ensuring that poor countries can raise tax revenue to fund their own development, then we need to address tax competition. And that is one fight the BEPS process has no intentions of fighting.