

Evaluation of the Independent Commission for the Reform of International Corporate Taxation for the Base Erosion and Profit-Shifting Project of the G20 and OECD

BACKGROUND

As stated in the ICRICT Declaration of June 2015, the G20/OECD BEPS project is a step in the right direction. It is a welcomed development and clearly has made progress that would have been thought of as impossible just five years ago.

It was only when several governments investigated and scandals such as the Luxembourg Leaks erupted that the curtains were drawn, revealing widespread tax abuse by multinational corporations. The G20 swiftly reacted in 2012 by calling on the Organization for Economic Co-operation and Development (OECD) to reform the international corporate tax system through the Base Erosion and Profit Shifting (BEPS) initiative. In September 2013, the BEPS Action Plan was approved as a G20 project and organized through the OECD for delivery by December 2015. The BEPS project is aimed at ensuring that multinational corporations are taxed 'where economic activities take place and where value is created'. This advance is certainly commendable and several reforms proposed in the BEPS project outcomes move in this important direction.

Although not perfect by any means, country-by-country reporting is a step toward transparency. For the first time ever, tax authorities will (potentially) have information on multinational corporations activities worldwide. A template of information on global operations and profits by country of multinational corporations has been created that will require reporting of company revenues, profits, taxes paid, employees and assets in each country where they do business.

Additionally, two important revisions to bilateral tax treaties, which will be available through a multilateral agreement, are step forward in ensuring that income attributions have economic substance. One of these proposals is a standard treaty abuse clause to prevent tax avoidance by routing income through conduit countries which are part of a treaty network. Known as a 'primary purpose test', this treaty provision provides more legal authority for countries to evaluate the economic substance of income attribution and challenge the characterization of transactions that have the primary purpose of avoiding taxation.

Secondly, a revision of the 'permanent establishment' or tax nexus rules will expand source countries' ability to tax economic activity occurring through commissionaire arrangements within their borders. This expanded tax nexus rule represents a modest but welcomed advance in shifting more taxing power to countries where economic activities take place. Finally, the multilateral arrangement is also commendable in that it saves valuable tax administration resources—which are scarce in all countries, but particularly low-income countries—because all of a country's individual bilateral agreements can be amended at once, provided that these treaty partners are also signatories to the multilateral agreement.

In our Declaration, we explain the system's inability to cope with a globalized, knowledge-based economy and how it works to disadvantage certain countries—both inside and outside of the OECD—as multinationals use the transfer price system to transfer 'reported profits' to low-tax jurisdictions. So when the BEPS Action Plan announced that a central focus of reform would be to this transfer pricing/separate entity system, it

was a welcomed acknowledgment, but the decision to defer discussion of profit-splits is a great disappointment. Expanding the application of profit-split rules in the transfer pricing methods would have been a step in reforming the system because the method is a move toward consolidation of profits.

The profit-split method already applies under the OECD's guidelines on transfer pricing under very limited circumstances. It combines company profits from groups of transactions (usually by activity) and then apportions them among jurisdictions by economic factors, such as revenue and expenses. The profit-split method acknowledges that 'comparables' used to set transfer prices very often do not exist—in theory or in practice. Increased use of this method was floated as a possibility at the outset of the BEPS process, but this work never transpired. Instead, the BEPS process produced additional transfer pricing methods that reinforce and add further variation to the current 'facts and circumstances' analysis of functions, assets and risks in the often elusive quest for comparables. While the added complexity attempts to patch up loopholes in the system, the patches make transfer pricing regulation an even greater drain of resources for tax authorities, create more uncertainty for taxpayers, open up new opportunities for tax arbitrage and generate conflict as different tax authorities opt for different methods.

As the BEPS project outcomes are presented to the G20 Finance Ministers, and the Annual Meetings of the World Bank and International Monetary Fund take place, reflection on the sufficiency of the BEPS project outputs as well as global tax reform beyond BEPS is critical. We explain here the primary limitations of the BEPS reforms—why they do not fully achieve the objective of ensuring that multinational corporations are taxed where economic activities take place and where value is created.

DEFICIENCIES IN THE RULES.

Transfer pricing. The biggest deficiency of the BEPS process has been its inability to address the core problem of our global tax system—the transfer pricing rules and more broadly speaking, the separate entity approach to taxation. The ICRIT Declaration provides an alternative: tax multinationals as single firms by combining their global profits and then allow each country where the corporation operates or sells goods to tax only the portion of profits attributable to the corporation's economic activity there. Unfortunately, the BEPS project has not taken this route to reform, or even considered it. The package of reforms only works within the entrenched separate entity system.

Arbitration. In the application of legal principles, complexity begets discretion, which further begets dispute. While we are relieved that mandatory arbitration rules did not make it into the BEPS proposed reforms, and that there has been an attempt to improve dispute resolution, we are concerned that a select number of developed countries within the BEPS project have taken steps toward greater use of arbitration. Although this agreement would not bind developing countries, it would place more pressure on them to go along with the crowd to attract much-needed investment by entering into private and confidential arbitration proceedings. The OECD's model tax rules already provide for mandatory arbitration of disputes unresolved after two years (the UN rules provide alternate provisions). Although it has often been argued that arbitration is quicker and less expensive, the OECD's own research has not backed up this claim. A 2012 OECD survey showed that the costs of arbitration proceedings averaged \$8 million and can exceed \$30 million. Consequently, arbitration often finds developing countries at a disadvantage because they lack the financing for such fees as well as legal teams of tax experts. Moreover, a central function of the public sector is dispute resolution. We believe that this core public function should not be privatized. Current standards for arbitration fall far short of what we should expect in a twenty-first century system of dispute resolution.

Transparency. Although country-by-country reporting is a welcomed reform, reporting will only be required for entities with revenues above \$845 million and will not be made public. This is particularly disappointing because public reporting would reveal the scale of tax abuse and would also provide data for public evaluation of the effectiveness of BEPS reforms in curbing base erosion.

Tax treaty reform. Although the reforms to tax treaties expand taxing rights of countries where business operations take place and in this respect, are a step forward, the proposals for reform for the tax nexus (permanent establishment) rules could contain greater acknowledgment of digital activity and services, which permeate our knowledge- and service-based global economy, and have become a major source of tax avoidance.

Tax incentives. One priority of developing countries is the reduction of tax incentives, which have played an important role in base erosion. Tax incentives have proliferated in recent years, and many countries, especially developing countries, have sacrificed large percentages of GDP for no or limited return, while often undermining other countries' tax base. Although work on tax incentives is not part of the BEPS Action Plan, a 'toolkit' on tax incentives was produced at the request of the G20 Development Working Group. This paper included recommendations for reducing the scope for abuse for tax incentives at the domestic level as well as supranational cooperation necessary to prevent a 'race to the bottom'. While the research and analysis of the draft is informative, the political will to produce actionable solutions is absent, primarily because not everyone has had a seat at the table. In our Declaration, we recommend that this work be undertaken through a globally representative body, which could monitor the effects of unfair tax competition. Given the huge losses in tax revenue every year from tax incentives, progress on this front would have been a benefit to developing countries.

INSUFFICIENT REPRESENTATION.

Although the G20/OECD BEPS process has included forty-three countries (the 34 OECD countries plus the 9 non-OECD G20 countries), their positions have been largely dictated by national economic concerns, or even worse, by special interests within their countries. Discussions in BEPS public consultation meetings have been dominated by multinational corporations, who consistently outnumber civil society, academic, labor, and country representatives combined, and are often doubly represented by their tax advisers and special industry groups. These corporations are predominantly headquartered in the United States and European countries, who act as staunch allies to protect the 'competitiveness' of their own multinationals. (The United States alone is home to 579 of the top 2000 global corporations according to *Forbes*.)

The lobby of the leading technology companies has been especially formidable. Indeed, it was the exposed tax abuses of these companies that fueled the flames of the tax squabble between the United States and Europe, and initiated the current reform process. This process set out to examine ways to eliminate harmful tax practices, such as 'innovation boxes' that give tax breaks to intellectual property and encourage shifting of profits and assets for the purpose of avoiding taxes. Yet, due to the immense pressures of the business lobby, in the end the BEPS process has only resulted in greater proliferation of these tax breaks, albeit with guidelines and thresholds. Another example of this pressure came during the BEPS consultation on taxation of the digital economy, when the leading technology companies, who commonly stake their claims at the forefront of technological innovation, stood united against any discussion of tax rules that would consider the concept of digital presence in the tax nexus rules. In echo, the home countries extolled the

need for ‘traditionally accepted’ and ‘durable’ principles such as physical presence. And in the end, the business lobby succeeded in preventing acknowledgement of digital activities in the tax nexus rules. Thus, despite the commendable efforts to open the door to meaningful reform, governments have not adequately performed their role as protectors of the public interest and have in many instances worked to support the interests of corporations in their jurisdiction.

We believe it is now time to consider international corporate tax reforms from a global perspective rather than the national economic advantage of a select number of countries.

WAYS FORWARD

As ICRICT has argued, the only effective cure for our current outdated system of taxing global profits is to step away from the separate entity tax approach and tax multinationals as single firms. Multinational companies should no longer be allowed to structure their business in multiple pockets around the globe that take advantage of low tax rates and accounting practices, which move money out of one pocket and into another through a simple stroke of a key. Although it is considered legal under the current ineffective rules, this kind of maneuvering affects the lives of real people because it drains public revenues that fund healthcare, education, infrastructure and other important public goods.

BEPS missed out on two important opportunities to move this agenda forward. First, the work on profit-splits under the transfer pricing scheme could have gone much further, but instead, went nowhere. Secondly, although country-by-country reporting is a huge step forward in providing a global picture of corporate activity and profits, it only applies to large companies and will not be made public. That’s why ICRICT recommended that such information on all corporate taxpayers (both public and private) be made public after 30 days of filing.

However, before these or any other recommendations can be properly considered, the appropriate institutional arrangements must be adopted. In this respect, global solutions to combat tax abuse require global representation. The current glut in global tax governance adds to the lack of international tax cooperation that can produce coherent rules to prevent tax abuse. Developed countries, led by the United States and the United Kingdom, demonstrated their staunch opposition to global representation on tax matters at the UN Financing for Development Conference in July 2015, and claimed that these issues are best left to the experts in the OECD. However, we believe that all countries should have a voice in creating global rules and that this conversation should take place within the United Nations.

We continue to call for an upgrade of the UN Committee of Experts on International Cooperation in Tax Matters to an adequately resourced intergovernmental Commission. We also call on UN Member States to initiate negotiations to draft a UN convention to combat abusive tax practices, which should later evolve into a convention that would adopt a consolidation and apportionment system for taxing global corporate profits. In the interim, and even in the OECD, developed countries should agree on a global minimum corporate tax rate. BEPS would have been an opportunity to come to such an agreement, but the moment has been lost.

However, this is not the end-point, but just the beginning of a new and wider debate on global tax reform. Our world has been changed by globalization. The global economy has transformed since the last century when the old rules were made by the United States and Europe. It’s time for smarter rules based on global negotiation and made in the public interest. It’s time to go beyond BEPS.